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Testimony to the ERISA Advisory Council on the Topic of Examining Income Replacement during Retirement in a Defined Contribution System
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Thank you for the invitation to speak at this hearing. How we, as a nation, address the issue of income replacement during retirement will have an increasing impact on hundreds of millions of individuals and families over the coming years and decades.

I am speaking today as an individual and my statement is not meant to represent the view of my employer nor the professional associations, the Society of Actuaries and the American Academy of Actuaries, of which I am a member. My statement reflects the views and experiences gained in more than 34 years of designing, valuing and managing plans and products containing long term guarantees for the financial security of individuals and their families. For the last 11 years of my career my primary responsibilities have been focused on retirement plans and guarantees for defined contribution plans provided by VALIC (The Variable Annuity Life Insurance Company), an organization providing administration, investment and guarantees for nearly 25,000 defined contribution plans and more than $71 billion of assets under management.

The challenges within this topic are myriad, however my comments will be focused on three areas: the needs of individuals planning for or in retirement, the concerns of plan sponsors of defined contribution plans and the challenges in providing products, services and resources to meet those needs and concerns.

The greatest emphasis in defined contribution plans in the last decades has been the accumulation of retirement savings and this has lead to a focus on investment returns and management fees. There is significant expertise available for plan sponsors and participants to aid them in evaluating these areas and the recently implemented ERISA Fee disclosure guidelines provide more information to both plan sponsors and participants.

For individuals, income replacement in retirement presents much greater challenges than they face during the accumulation of retirement savings due to additional unknown factors: (1) how long they will live and (2) what expenses and inflation will they face during their retirement years. These challenges are exacerbated by the fact that whereas in their “accumulation years” they have three “levers” for control: (1) how much they save; (2) how they invest and (3) how long they choose to work before retirement; in retirement they have only two primary “levers”: (1) how much they spend and (2) how they invest or manage their financial assets.

For plan sponsors, providing new products and services pertaining to income replacement during retirement creates concerns because providing meaningful guarantees to participants of lifetime retirement income can entail guarantees which will last for many decades. Plan sponsors need guidance and safe harbors regarding their role in making those guarantees available for plan participants.

The challenges for the financial and insurance industries in meeting the retirement income needs of participants and the concerns of plan sponsors involve the management of both longevity risks and of guarantees which last for decades, which can include significant "re-investment" risk. Another challenge is the reluctance of participants to make the difficult trade-off of giving up some aspects of liquidity and control of their assets for the protection against longevity risk – the risk of "living too long".

I will now address the specific questions posed by the Council.

What options could be made available to plan participants to best utilize their account balance(s), and to facilitate the goal of securing a stream of income over the elected period designated by the participant?

There are a wide range of options available for plan participants in securing a stream of income. Broadly speaking, these fall into either (1) managing investments and income distributions; (2) purchasing longevity guarantees, primarily through income annuities or income benefit products (GMWB or GMIB);and (3) a combination approach.

In managing investments and income distributions the participant can benefit from professionally managed "target date" funds or "bond ladders" and from tools designed such that they will not outlive their income. These approaches are far more sophisticated than simply using the widely known "4%" guideline, as they take into account asset allocation and automate the calculation of a recommended income amount, which in some programs is redetermined annually. The participant benefits from having complete control of their assets and retains individual choice in the amount of withdrawals, but this approach provides no underlying guarantees for longevity risk other than taking that into account in the target portfolio and income recommendation. Simply stated, unless their financial plan targets an extremely long life span, such as to age 110, an individual cannot be sure that they will not run out of assets or need to significantly reduce their income withdrawals in a "managed distribution" strategy. Even if they meet their targeted investment return, an individual has a risk of living past a specific age, whether that is a typical life expectancy to their mid-80's or a much higher age such as 95. Targeting an extremely long life span will likely result in a much lower annual income amount than can be achieved using longevity guarantee products and could still leave a material risk should life expectancy continue to rise. Longevity guarantee products are the only products which eliminate the risk of "living too long". While a participant can ensure that they never outlive their assets simply by reducing the amount they withdraw from their accounts should they live longer than presumed in their financial plan, only products such as Single Premium Immediate Annuities, Deferred Income Annuities and Guaranteed Minimum Benefits effectively transfer longevity risk from the participant.

Annuity based benefits available to plan participants can include fixed, variable or a combination of fixed/variable payment options. These benefits can be "life only" benefits which last for life or also include a minimum number of years in which payments may be made (a certain period), which provides a greater protection against "dying too soon" but which reduces the monthly income amount available compared to "life only" benefits. They may be based on a single life or on joint lives, with payments continuing unreduced or at a reduced rate after the first death. Annuity payout benefits are more commonly available within small plans, which are more likely to be funded with annuities than in larger plans, which are more often funded with mutual fund based products. Plans which have focused primarily on fee levels may be less likely to have strong annuity income guarantees available as those guarantees may increase fees.

Variable annuity payouts generally include an "assumed interest rate" and this gives the participant the chance to tailor their income expectations. By selecting a lower assumed interest rate the initial income payout will be lower, but benefit payments could increase to the extent that actual returns on variable fund investments exceed that assumed interest rate. This can provide some protection against inflation as selecting a low assumed interest rate will increase the likelihood that excess investment returns will occur. Using variable payout options does, however, create the risk that income payouts could decrease. Any fluctuation in the level of income payouts would reflect only investment returns and would not reflect any changed expectations in longevity, as those risks are transferred to the annuity provider.

Annuity based benefits can also be varied by choosing to use only part of existing assets to purchase an annuity income option and it may be possible to purchase annuity income over time, spreading the risk with fixed annuities that purchase rates may be high at the retirement or annuitization date due to a low interest rate environment.

What factors should the participant consider with respect to income replacement options described above?

Although two of the key levers for a participant for income replacement options are how much they will spend and how they will manage their financial assets in retirement, at the individual participant level there are many factors to consider.

In determining what income they need from their retirement income plan, an individual must look at their own specific needs and circumstances, including

- When they will retire
- Other sources of income
- Other financial assets
- Taxes
- Health insurance
- Long Term Care insurance
- Their own health and that of their spouse, if applicable
    - as it affects longevity
    - as it affects medical costs
- Inflation
- Possible improvements in longevity
- Specific family support and circumstances
- Portability

The choice to continue working longer is one of the key decisions for a participant who is still employed. In the SunAmerica Retirement Re-Set Study conducted in 2011, those surveyed indicated they planned to retire later, at age 69 as compared to age 64 in the study conducted in 2001. This is a very important factor in securing income replacement in retirement which will last a lifetime.

Many financial planners emphasize trying to first build a “survival” level of income based on guarantees so the individual has some level of assurance of an income they cannot outlive. This base level is primarily from defined benefit plans, social security, or guaranteed lifetime income products.

Guaranteed lifetime income products generally involve a choice between asset control and the level or cost of guarantees. Currently individuals have been reluctant to purchase immediate annuities or deferred income annuities. This may be due to a lack of understanding of the leverage available for addressing longevity risk in these products.

As a general guide, transfer of longevity risk involves pooling of risk. While the chance that a specific individual will live past 90, 95 or 100 is exceedingly difficult to assess, the chance that within a group of 10,000 individuals a certain number will live past those ages is more certain. The “law of large numbers”, transferring individual risk to a larger pool, is a key component in risk sharing and most annuity guarantees involve that risk transfer. To the extent an individual accepts the financial risk of not passing on as many assets to their heirs if they “die too soon” they can better leverage the cost of insuring the risk of “living too long”. The financial organization providing the guarantees for products with longevity guarantees relies on the principals of risk pooling, often including the professional management of investments and backed by the financial strength of the organization.

An individual must assess what level of “base income” they need and have a realistic assessment of their own attitude towards risk, including that of their spouse if applicable. Although many individuals place a high priority on leaving assets to their heirs, there may not be sufficient emphasis on what it will mean to their spouse, children or grandchildren if the participant outlives their retirement income. Education is needed to help participants better appreciate that being financially self sufficient for the remainder of one’s life may be a greater gift to one’s heirs’ than a potentially larger inheritance.

VALIC has preliminary internal studies of the plans in which it provides services showing that individual selection of guaranteed income options (primarily GMIB options) are more than 3 times higher in the non-ERISA plans than in ERISA plans for plan participants between age 60 and 70. We have not completed an analysis regarding why this disparity exists and whether it is due in part to fiduciary concerns in making those options available in ERISA plans or due to the common practice by participants to aggregate retirement assets into Individual Retirement Accounts (therefore removing them from the ERISA plan). This disparity may indicate that plan participants can be greatly affected by options available within plans. These preliminary results may be an indication of how the Council’s activities to enhance education and income options available could dramatically affect participants’ options for securing income replacement in retirement.

What are the risks plan sponsors face with respect to certain options, and how can these risks be minimized?

Plan sponsors are generally businesses who utilize defined contribution plans as a way to attract and retain their employees. As such, they must balance the benefit the employer receives by providing the plan against the cost and potential risks in acting as a fiduciary of that plan. In looking at retirement income options, meaningful guarantees of lifetime income inherently involve very long term guarantees. As a fiduciary, the plan sponsor must address the ongoing financial strength ratings of organizations providing those guarantees. Because these guarantees may last for many decades, plan sponsors needs additional guidance in addressing those responsibilities and possible relief regarding future liability.

Long term guarantees may also have inherent portability issues. Portability is important both at the participant level, who may change employers and desire to aggregate all of the defined contribution assets and at the employer level, who may need to periodically re-evaluate options offered within the plan as part of their fiduciary responsibility.

Plan sponsors are also faced with the difficulty of analyzing fees or costs vs. benefits provided, particularly for options with material longevity guarantees.

The risks to plan sponsors can be minimized by having clear guidance on the fiduciary responsibilities regarding evaluation of fees or costs vs. benefits for longevity guarantees and in regard to the potentially long term nature of those guarantees. In addition to acting prudently in their role as plan sponsor, the plan sponsor is also obligated to manage the potential liability to the employer and may choose to avoid potentially long term fiduciary risks without clear guidance.

The ability to do a "partial rollover" of options with long term guarantees to an IRA may help address the participant level concerns regarding portability. If the participant changes employers or the employer no longer allows an option within a retirement plan, the ability to retain that option by rolling it to an Individual Retirement Account may help address portability issues. Alternatively, the ability to retain contracts already within a plan for participants already annuitized (even if the annuity provider is deselected) or distributing from the plan any existing annuity contracts would aid in portability. To the extent that an option requires ongoing contributions, portability could remain an issue.

What are the factors to be considered by the plan sponsor regarding the options to be offered under the plan, such as participant demand, product portability risks, and fee structure?

The plan sponsor offers the defined contribution plan as a means to attract and retain employees. To that extent they may place greater emphasis on the accumulation aspects of a plan rather than the income aspects unless doing otherwise would enhance their ability to attract or retain employees. Part of the decline of offering defined benefit plans may be due to their being relatively under-valued by employees, which creates an imbalance in the cost incurred by the employer against the benefit they gain in attracting and retaining employees.

Similarly, income options are often complex and many employees are not sufficiently knowledgeable regarding how much income they will need in retirement, the potential impact of inflation and how changes in longevity could affect their retirement. This lack of knowledge may lessen their ability to properly evaluate the value of guaranteed lifetime income options. Basic education regarding all of these factors is needed for participants to be able to appropriately value these options, the costs involved and the role various options can play in providing income in retirement. Without participant demand or appeal, fewer plan sponsors may be inclined to address the fiduciary responsibilities, portability issues or other requirements for offering a wide variety of options within a plan.

In considering education alternatives with respect to income replacement, what role should an employer play with respect to retirement savings held outside of the employer-sponsored plan?

To determine what income replacement options a participant will utilize, the participant must take into account their complete financial resources, not simply those pertaining to those of the employer sponsored plan. These types of analyses can be quite complex depending on the circumstances and financial assets of the participant. While the employer may not be obligated to provide more sophisticated planning which could include retirement savings or financial assets outside of the plan, the ability to offer that level of planning may aid the employer in attracting and retaining employees.

Retirement planning seminars and education can address both a participant's plan assets and outside financial resources, however they are unlikely to address the specific circumstances of a participant. Automated "self serve" planning tools can be provided, however many participants may not be either sufficiently knowledgeable or sufficiently confident to effectively use such tools The ability to provide optional fee based planning services within a plan may greatly aid participants. Having clear guidelines on the fiduciary responsibilities in making those types of optional planning services available may increase their use across plans.

For options with guarantees, including education alternatives with respect to savings held outside the plan can create other issues. As an example, longevity guarantees offered within a plan must generally be offered at "unisex" rates, whereas longevity guarantees offered outside of a plan most commonly have rates which vary by gender. To the extent that longevity guarantees increase in utilization, if males begin purchasing guarantees outside the plan (where they may have lower purchase rates due to shorter life expectancies), rates for guarantees within a plan may increase.

What fee disclosure requirements would apply for providers/plan sponsors to participants with respect to income replacement options?

Current fee disclosure requirements are primarily aimed at recordkeeping and investment management expenses and current disclosures aid plan sponsors in meeting their fiduciary role and aid participants in selecting and monitoring their investment choices. Fee disclosure can emphasize fees to the detriment of considering benefits provided, particularly when benefits such as long term guarantees are involved.

Clear disclosure of the guarantees provided, the financial strength ratings of any provider and the fees charged for those guarantees are important for both the plan sponsor and participant.

Some income replacement options, such as Single Premium Immediate Annuities, do not have specific fees associated with those guarantees and more appropriate disclosures may include the income guaranteed, the description of that guarantee (life only, single life or joint and survivor, inflation protection, etc), the purchase price and the current financial strength rating of the provider.

What unique considerations, if any, would be required by the fiduciary for any of the options being offered?

Some income replacement options with long term guarantees do not easily fit into the analyses which are now commonly done as those analyses often focus on providing a choice of investments funds, education and recordkeeping with appropriate management fees. To a large extent these components are more or less measurable and fungible. Retirement income options with long term guarantees are more varied and complex and include the added component of evaluating the financial strength of a company providing a guarantee that potentially stretches for decades into the future.

Although there are current guidelines pertaining to the selection of annuity providers for a plan, plan sponsors concerned about future liability may be more comfortable if it was made very clear that the standard is based on financial strength ratings at the time of selection of those providers and with guidance on the frequency of any reviews of financial strength which might be prudent (assuming the fiduciary doesn't otherwise become aware of the information necessitating the need for an earlier review).

Additionally, some of these options (GMIB/GMWB, deferred income annuities) continue to evolve and the fees and guarantees on such options may fluctuate quickly and materially due to changes in the economic environment. The requirements of a fiduciary addressing these issues may differ materially compared to evaluating the "accumulation" phase of plans.

Do the fiduciary concerns interplay with other potential barriers, and if so, what are those barriers?

Fiduciary concerns and fee disclosure requirements both interplay in the choice of retirement income options offered within a plan. The guaranteed income options available in the marketplace are offered in a dynamic environment and many annuity companies have ceased to offer or have significantly modified the fees or benefits of such options. While the plan sponsor has a fiduciary responsibility regarding options offered within a plan, the combination of that responsibility and the fee disclosure requirements associated with fee changes may further limit what guarantees an annuity company may be willing to offer. Longevity guarantees may include hedging expenses and costs which are volatile and the ability to quickly modify the costs or guarantees offered can be a critical part in managing those guarantees. The added complexity of satisfying a plan sponsor's fiduciary obligations and the expense of fee disclosures required by such changes could reduce the availability of those options or increase the associated fees.

In closing I would like to thank the Council for the opportunity to present these views. I believe there is a significant gap in the income options widely available and utilized in defined contribution plans and those more widely available in the marketplace. I believe there is an even wider knowledge gap between what participants know about managing replacement income in retirement and in what most experts would advise them to learn. The work of the Council is crucial in closing these gaps and thereby helping participants prepare for and enjoy a secure retirement.