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ERISA ADVISORY COUNCIL

WORKING GROUP EXAMINING INCOME REPLACEMENT DURING RETIREMENT YEARS IN A DEFINED CONTRIBUTION PLAN SYSTEM

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I am Mike Hadley, a partner with Davis & Harman LLP, and I am pleased to appear before the ERISA Advisory Council's working group examining income replacement during retirement. This is an important issue that the retirement community is working hard to address.

I appear here on my own behalf and not on behalf of any client. Davis & Harman LLP represents a range of plan sponsors, financial institutions, and trade associations active in the retirement industry, and our clients do not all share identical views. They all agree, however, on the importance of giving Americans the tools they need not just to accumulate adequate retirement savings, but to manage those savings effectively in retirement.

Participants have many choices to manage assets in retirement, including annuity and non-annuity approaches. 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 the public and the private sector.

The Departments of Labor and the Treasury received an amazing response to their request for information on lifetime income, issued more than two years ago. Many stakeholders in the retirement industry came forward with good ideas, some of which are already on the regulatory agenda. Today, I would like to focus on areas where policymakers, particularly the Department of Labor (the "Department" or "DOL"), can work to address uncertainty in how ERISA regulates the use of annuities and other insurance products in retirement plans. Many of these uncertainties arise under the tax code, but I will focus on non-tax issues under ERISA.

Legal uncertainty is not the sole reason for the low uptake of annuity options by plan sponsors and participants. But it is something that is within the power of policymakers to address.

After providing a background on lifetime income, my statement will address the following:

- Retirees have a range of choices in plans and IRAs to help them turn their savings into a stream of income, and financial service providers continue to innovate new products and strategies.

- The Department should issue guidance clarifying the circumstances under which plans and service providers can provide education to participants about their lifetime income choices.
- The Department should clarify the uncertainty regarding the status of annuity contracts, and certificates issued under group annuity contracts, distributed from plans.
- It is incumbent upon the Department and the attorneys that advise plan fiduciaries to make very clear that ERISA's fiduciary obligations do not require that a fiduciary who selects annuity provider have a crystal ball that infallibly predicts the future financial condition of the insurer.

Background

The assets accumulated in account-based retirement plans, including 401(k), 403(b), and 457(b) plans, and IRAs, now dwarf what is saved in defined benefit pension plans. Defined contribution ("DC") plans and IRAs held $9.4 trillion as of year-end 2011, while private defined benefit plans held only $2.4 trillion.[1] Individual retirement accounts and individual retirement annuities are now *the largest component of our retirement system*—most of those assets generated in employment-based plans and then rolled over. By this measure, our account-based system has been a success in generating significant savings earmarked for retirement.

Much of the talk about lifetime income centers around the wave of baby boomers who are beginning to retire, but they are not the first Americans to need to make personal savings last during retirement. We should be careful to separate the problem of helping Americans who *have* accumulated significant personal savings for retirement make those savings last, on one hand, from the problem of ensuring that Americans do not reach retirement with more than just Social Security to rely upon, on the other. Today we focus on the former problem. (The latter is a much more difficult problem to solve, because many Americans have insufficient resources during their working careers, and it is not easy to ensure they will not arrive at retirement with the same insufficient resources.)

There is significant evidence that retirees are *anxious* about their ability to make their savings last, and that plan sponsors are *concerned* about offering their employees the right tools to help them. The Employee Benefits Research Institute reports that 45% of retirees feel "financially stressed."[2] Recent data from MetLife suggest a disconnect between what plan

[1] Governmental plans held $4.5 trillion, but this number represents some defined contribution savings like the Thrift Savings Plan. *ICI Release: Quarterly Retirement Marketing Data, Fourth Quarter 2011*, Investment Company Institute (Apr. 2, 2012), http://www.ici.org/research/retirement/retirement/ret_11_q4.

[2] EMPLOYEE BENEFIT RESEARCH INSTITUTE, THE 2012 RETIREMENT CONFIDENCE SURVEY 12 (2012), *available at* http://www.ebri.org/pdf/surveys/rcs/2012/EBRI_IB_03-2012_No369_RCS.pdf.

sponsors think their workers need and what their plans provide.[3] Nearly half (44%) of plan sponsors in MetLife's survey said that the majority of their DC plan participants would prefer to "receive at least part of their retirement savings as monthly income for as long as they live rather than receiving all of it in a lump sum that they would invest themselves." Furthermore, 68% of plan sponsors said they believe the majority of their DC plan participants favor "guarantees that offer stable but somewhat lower returns" over a "higher degree of risk because the returns could be greater." And yet, only 16% of plan sponsors in that survey offer any form of lifetime income option.

Retirees similarly show a disconnect between their reported interest in guaranteed income products and the use of these products. Nearly half of workers report that they are "very likely" or "somewhat likely" to purchase a guaranteed income product at retirement, and yet only 12% actually do purchase such a guaranteed income product at retirement.[4] Similarly, when defined benefit plans offer a lump sum, a significant majority of employees elect a lump sum.[5]

It is a great paradox that, when given the choice, Americans overwhelmingly choose to manage their own assets in retirement through use of lump sum distributions preserved in an IRA, but when they do not have that choice, as with Social Security or a traditional defined benefit plan that lacks a lump sum option, they do not express displeasure at having an annuity stream for life.

Innovative Strategies Available in Plans and IRAs

When a worker arrives at retirement with a significant amount of assets and sits down to figure out how to translate those savings into retirement income, there a variety of strategies available. All of these strategies involve tradeoffs—none is universally better than another. Many advisers suggest a combination of approaches. Here is a brief overview of some of the key products and strategies.

Installments. Installment payments and systematic withdrawal plans (SWPs) from a plan account or IRA are methods to spread income from retirement savings over time. One advantage of this approach is flexibility—it gives a retiree the ability to address "lumpy" spending and a reserve to meet unexpected expenses like health care needs.

Payout Funds. A number of financial service companies like mutual funds have brought to market "payout" funds designed to be investment vehicles and payment vehicles all in one; these funds are managed with sophisticated payout designs meant to provide a predictable, albeit

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[3] METLIFE, RETIREMENT INCOME PRACTICES STUDY: PERSPECTIVES OF PLAN SPONSORS AND RECORDKEEPERS FOR QUALIFIED PLANS (2012), *available at* http://www.metlife.com/assets/mlr/403b-resource-center/MetLifeRetirementIncomePracticesStudy.pdf.

[4] EBRI, *supra* note 2, at 28-9.

[5] *See* GOVERNMENT ACCOUNTABILITY OFFICE, GAO-09-642, PRIVATE PENSIONS: ALTERNATIVE APPROACHES COULD ADDRESS RETIREMENT RISKS FACED BY WORKERS BUT POSE TRADE-OFFS 19-20 (2009).

not guaranteed, monthly check. Some insurance companies are developing and offering products that combine mutual fund investments with annuities.

Delaying Social Security. One of the most overlooked strategies to generate retirement income and insure against longevity risk is to live initially on liquid assets (or work longer) and delay taking Social Security benefits. An individual can, in effect, purchase annuity income by delaying receipt of Social Security benefits. Very generally, benefit adjustments under Social Security are actuarially fair, meaning that a dollar spent delaying Social Security receipt should return, on average, a dollar in annuity income.[6]

Annuities. Annuities provide insurance protection against longevity risk by pooling that risk among a large group of individuals, so that no single individual bears the burden of the entire risk alone. These insurance products are available in a variety of forms that can be tailored to meet the individual's or the plan's specific needs.

- Traditional life-contingent annuities, whether purchased at retirement or during one's working years and then "annuitized" at retirement, provide periodic income payments that cannot be outlived. When purchased incrementally over time, traditional life-contingent annuities also can help hedge against interest rate fluctuations that affect annuity purchase rates.

- Life-contingent variable annuities protect against longevity risk as well as inflation risk by providing lifelong income and access to returns that have the potential to exceed the rate of inflation. Such products also can offer "guaranteed minimum accumulation benefits," which guarantee a minimum rate of return before annuity payments commence, while still allowing the holder to participate in equity markets. Similarly, "guaranteed minimum income benefits" under variable annuities can provide lifetime income that is based at least in part on equity market returns while still providing a guaranteed floor, below which the periodic payments will not fall.

- Annuity products also can offer "guaranteed lifetime withdrawal benefits" – whether embedded in a deferred annuity product or offered as a "stand-alone" product coupled with an individual account. Both types provide participants with flexibility to meet their current income needs while insuring them against the risk of outliving their retirement assets.

- "Longevity insurance" provides retired individuals an affordable way to protect against the risk of running out of income from their other retirement assets if they outlive their life expectancy. These products, which are the subject of a major Treasury

[6] *See* STEVEN SASS, CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE ISSUE BRIEF NO 12-10, SHOULD YOU BUY AN ANNUITY FROM SOCIAL SECURITY? (May 2012).

> proposal,[7] are at their heart deferred annuities that, for a modest premium, provide an annuity starting date at advanced age, like 85.

At the end of 2011, variable annuity assets invested in qualified retirement plans totaled $1.01 trillion, or 67.4% of total variable annuity assets.[8] Group deferred annuities often function as the funding vehicle for a defined contribution plan, wrapping together investments, administrative services, and the offering of annuity distribution forms for participants. Increasingly, insurers are making available through these group annuity vehicles a variety of insurance products that can be tailored to meet the needs of retirees.

One of the myths that persist about annuities is that every annuity presents the risk of financial loss if the annuitant dies young – the proverbial question of "what if I get hit by a bus right after I buy it?" Insurance products can be designed with features to address these risks, like refund features, terms certain, and return of premium and other death benefits. These optional features generally reduce the annuity payment, but for some, that trade-off meets their needs and addresses their concerns.[9]

Uncertainty About Distribution Education

Although this might change, for now relatively few defined contribution offer access to all of the products and strategies described above. Most of these products and strategies are, however, available in the marketplace through a rollover to an individual retirement account or annuity. It is critical that retirees have an understanding of the choices available to them, including choices beyond those offered in their plans. At retirement, a worker is particularly focused on learning his or her choices. We need to facilitate an education process at that critical point.

In my view, one of the most successful regulatory projects DOL has ever undertaken is Interpretative Bulletin ("IB") 96-1, which provides guidance on the kinds of investment education that can be provided without triggering fiduciary status.[10] Since IB 96-1 was issued, virtually every 401(k) service provider has developed a robust education program available to participants that helps them understand basic investment concepts like risk and diversification.

In IB 96-1 the Department set forth a framework for plans and their service providers to provide an education program without uncertainty about tripping into fiduciary status and engaging in a prohibited transaction. The Bulletin makes clear that its relief applies "irrespective of who provides the information (e.g., plan sponsor, fiduciary or service provider), the frequency

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[7] Longevity Annuity Contracts, 77 Fed. Reg. 5443 (Feb. 3, 2012).

[8] INSURED RETIREMENT INSTITUTE, IRI FACT BOOK 81 (11TH ED. 2012).

[9] It is sometimes said that these features also may allow an individual to address a psychological barrier to purchasing an annuity that is economically rational.

[10] 29 C.F.R. § 2509.96-1.

with which the information is shared, the form in which the information and materials are provided (e.g., on an individual or group basis, in writing or orally, or via video or computer software), or whether an identified category of information and materials is furnished alone or in combination with other identified categories of information and materials." Thus, even though this education might lead a participant to select a service provider's affiliated investment, a pie chart, graph, or other asset allocation model is not a "recommendation."

Studies of actual participant holdings suggest that, on average, participants do a fairly good job of diversifying their accounts appropriately for their age.[11] (The increasing use of target date funds and other qualified default investment options will likely continue this trend.) The investment education facilitated and encouraged by IB 96-1 is an important factor in this success.

Contrast the robust education programs most participants see regarding asset accumulation and investment with the materials they receive about their distribution options. In many plans the sole education material is the mandated 402(f) notice.[12] Service providers and plans rarely modify the IRS' sample notice because providing the notice is a regulatory requirement. This notice does a reasonably good job of explaining the tax consequences of failing to do a rollover, but does not do much more than that.

In Advisory Opinion 2005-23A, the Department explained that it would not constitute investment advice with respect to plan assets to recommend that a participant roll over his or her account balance to an IRA to take advantage of investment options not available under the plan. Further, provided the recommendation comes from someone who is not a fiduciary, no prohibited transaction will result. This was an important step towards removing the uncertainty associated with helping participants make informed distribution choices.

But there continues to be uncertainty about the interplay between helping participants make informed decisions with their distribution and ERISA's fiduciary duties. For example, Advisory Opinion 2005-23A seems to suggest that if an entity is already a fiduciary for some other purpose, a recommendation to roll over a distribution would be investment advice. This is inconsistent with the general ERISA notion that someone is a fiduciary only with respect to those actions that constitute fiduciary acts.[13] It also suggests that ordinary service providers (who often serve in the limited fiduciary role of a directed trustee) cannot assist participants with rollovers, but advisors with no oversight from the plan sponsor can.

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[11] *See* INVESTMENT COMPANY INSTITUTE, 2012 FACT BOOK, at 110-11, *available at* http://www.ici.org/pdf/2012_factbook.pdf. For example, since 1999, the share of 401(k) accounts investment in company stock has continued to shrink, and recently hired 401(k) participants tend to be less likely to hold employer stock. *See* EMPLOYEE BENEFIT RESEARCH INSTITUTE, 401(K) PLAN ASSET ALLOCATION, ACCOUNT BALANCES, AND LOAN ACTIVITY IN 2010 (2011), *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_12-2011_No366_401(k)-Update.pdf.

[12] IRS Notice 2009-68, 2009-39 I.R.B. 423.

[13] ERISA § 3(21).

The Department has suggested that it might change the views expressed in Advisory Opinion 2005-23A, and in particular the Department's proposed fiduciary regulation asked for comment on the issue.[14] It is possible that the fiduciary regulation, if finalized, will treat many "recommendations" related to distributions as fiduciary investment advice, including the simple act of helping a participant understand their distribution choices under the plan and the kinds of products that are available in the market to meet their needs. Without an expansion of IB 96-1 to include education on the "decumulation" phase of retirement, participants could be left with virtually no assistance.[15]

Uncertainty About Status of Distributed Annuities

Historically, annuities were distributed from plans in one of two ways. First, a terminating defined benefit plan may purchase an insurance contract and distribute the contract (or a certificate under the contract) to participants. Second, a defined contribution plan might offer an annuity as a distribution option.

A distributed annuity contract that satisfies a variety of qualified plan requirements is a tax-deferred vehicle.[16] Distributed annuity contracts need not, however, satisfy all the requirements of an ongoing qualified plan. Thus, distributed annuity contracts straddle the world of qualified plans and non-qualified annuities.

It is preferable from the perspective of an ERISA plan to distribute the annuity contract if that contract would no longer be considered a plan asset subject to reporting on the Form 5500, and an in-kind distribution would more clearly establish that the participant should look to the insurer, rather than the plan, for any questions. For this reason, it would be helpful if the DOL issued guidance clarifying the status of distributed annuity contracts as plan assets.

The only Department guidance addressing whether a distributed annuity contract is a plan asset is a regulation dealing with the extent to which a participant is covered by a plan.[17] It effectively provides that an individual is not a participant covered by a pension plan for purposes of ERISA if (i) an annuity contract has been issued to the individual, (ii) the entire benefit rights of the individual are fully guaranteed by an insurance company, and (iii) the rights under the contract are enforceable solely by the individual without the employer's involvement. The Department has clarified that the "entire benefit rights" of an individual are not guaranteed or

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[14] Definition of the Term "Fiduciary," 75 Fed Reg. 65263 (Oct. 22, 2010). *See also* Investment Advice—Participants and Beneficiaries, 76 Fed. Reg. 66136 (Oct. 25, 2011).

[15] The current proposal would exempt investment education described in IB 96-1. As stated earlier, that would protect only education about accumulation of assets, not spend down, because the former is all that IB 96-1 currently covers.

[16] Treas. Reg. § 1.402(a)-1(a)(2) (describing tax treatment of a plan distributed annuity contract and referencing qualification requirements that apply to the contract after distribution).

[17] 29 C.F.R. § 2510.3-3(d)(2)(ii).

distributed for purposes of the regulation if an employee is continuing to accrue benefits.[18] Instead, the regulation is directed at "situations where employment has been severed, where the employee is fully vested and changes into employment not covered by the plan, or where the employee has earned the maximum benefit he can earn under the plan."[19]

This regulation does not address a situation where a participant takes an in-service distribution of an annuity contract and continues to receive contributions to the plan, but not to the contract.[20] In recent years, this distinction has become more important as "in-plan" lifetime income products proliferate. In many cases, a participant will wish to receive the insurance protection built into the contract through a distribution. If the participant wishes to take the annuity out of the plan, the contract should no longer represent a plan asset.

The result should be the same even if what is distributed to the participant is an individual certificate under a group annuity contract. It may be attractive for a plan to acquire a group annuity contract as a vehicle for offering payout annuities. However, the plan may distribute all of the rights under the arrangement by issuing individual certificates that are effectively equivalent to individual annuity contracts. So long as the participant can fully enforce his rights under the contract directly with the insurer under the certificate, a distributed individual certificate should cease to be plan assets even if the plan or plan sponsor continues to own the group contract.[21]

In order to facilitate the offering of an annuity that is purchased incrementally over time as an investment option within a plan, we need certainty about the status of that guarantee once it leaves the plan and become enforceable by a participant.

<u>Uncertainty about Fiduciary Duties Associated with Annuities</u>

In the responses to the Request for Information, there was significant discussion of the fiduciary duties associated with offering annuities in connection with defined contribution plans. The concern is that, in the unlikely event that an insurer is insolvent, the fiduciaries of the plan that originally offered that provider's annuity will be liable for not foreseeing the future.

There is no reason that these concerns should exist. Annuity contracts have a long history in the retirement plan context. Many of the earliest employer-sponsored retirement plans

[18] *See* 40 Fed. Reg. 34533 (Aug. 15, 1975) (preamble to regulation); ERISA Advisory Op. 77-10 (June 2, 1977).

[19] ERISA Advisory Op. 77-10.

[20] It is, however, implicit in Interpretive Bulletin 95-1 that a distribution of an annuity contract ends plan asset status. The Interpretive Bulletin applies to both ongoing plans as well as terminated plans. However, its primary application is to terminated plans. As a result, the notion that an in-kind distribution of an annuity contract ends plan asset treatment has been somewhat obscured.

[21] *Cf.* IRS Revenue Ruling 2011-7 (distribution from a 403(b) plan of a certificate from a group annuity contract evidencing fully paid benefits under the contract to each participant or beneficiary whose accumulated benefits are funded by a group annuity contract constitutes a distribution).

were arrangements where employers made contributions to group or individual annuity contracts. Section 403(b) annuity plans predate 401(k) plans by decades. In fact, ERISA provides a special exception from the plan asset rule for only two kinds of products—investment companies registered under the Investment Company Act of 1940 and guaranteed benefit policies issued by an insurer qualified to do business under state law,[22] precisely because these products come with comprehensive regulation that made separate ERISA regulation unnecessary. ERISA requires, after all, that the *only* way to terminate a defined benefit plan is to purchase annuities to provide benefits under the plan that cannot be paid in a lump sum.[23]

The issuance of Interpretative Bulletin 95-1, viewed as a response to the well-publicized developments involving Executive Life Insurance Company,[24] began an odd process where the ERISA world convinced itself that there might be a special "tail" fiduciary liability associated with offering annuities. But no investment product is risk-free, and ERISA does not require plan fiduciaries to have an infallible crystal ball. ERISA requires "prudence, not prescience."[25]

The Department has been asked repeatedly to provide safe harbor relief to allow a fiduciary to offer an annuity without fear, however unjustified it is. The recent amendments to IB 95-1 to clarify that the "safest available annuity" standard does not apply to defined contribution plans and the issuance of the annuity safe harbor for individual account plans were positive steps.[26]

In the annuity safe harbor regulation, the Department addressed this "tail" liability in a way that is very helpful, but not widely enough recognized, by providing in the regulation that the evaluation of an insurer need occur no later than when the annuity is selected for distribution of benefits. A fiduciary is not required to review the appropriateness of its conclusion with respect to any annuity contract purchased for any specific participant.[27] Although these statements relate to the application of the safe harbor, inherent in them is the assumption that a fiduciary who acts prudently in selecting an annuity provider need not forever worry about that decision.

Despite these positive developments, many continue to believe that the safe harbor's requirement that a plan fiduciary "appropriately conclude that . . . the annuity provider is financially able to make all future payments under the annuity contract"[28] serves as an

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[22] ERISA § 401(b).

[23] ERISA § 4041(b)(3)(A).

[24] Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974, 60 Fed. Reg. 12328, 12328 (Mar. 6, 1995).

[25] *DeBruyne v. Equitable Life Assurance Soc'y*, 720 F. Supp. 1342, 1349 (N.D. Ill. 1989), aff'd, 920 F.2d 457 (7th Cir. 1990); *see also id.* 920 F.2d at 465 (''[T]he ultimate outcome of an investment is not proof of imprudence.'').

[26] 29 C.F.R. § 2550.404a-4.

[27] 29 C.F.R. § 2550.404a-4(c).

[28] 29 C.F.R. § 2550.404a-4(b)(4).

impediment to the offering of annuities as distribution options. This requirement is also somewhat unfair, which can be illustrated by the following thought experiment. Imagine that the economists at EBSA's Office of Policy and Research were tasked by Congress with evaluating all of the annuity issuers in the United States and making a prediction about which ones will make all future policy payments, and which annuity issuers will not. Further imagine that the Department was required by law to pay, out of its own budget, any and all annuity payments with respect to an insurer that EBSA predicted *would* make all future payments, but unexpectedly became insolvent, to the extent not covered by state guaranty pools. I suspect EBSA would not wish the latter on itself.

It is not, and should not be, the law that offering an annuity distribution turns plan fiduciaries into stop-loss guarantors of insurers whose financial condition unexpectedly deteriorates despite the watchful eye of state insurance commissioners. It is incumbent upon policymakers – and the attorneys that advise plan fiduciaries – to remove any uncertainty on this point.

Conclusion

There is no one single approach to achieving lifetime income that works for everyone. The U.S. private retirement system is fundamentally voluntary—employers have broad flexibility in whether to offer a retirement plan and in how the plan is designed, and workers are by and large free to manage their retirement savings to meet their individual needs. Annuities and similar products do not meet every retiree's needs but for many they are a valuable and important tool. The goal of the Department and other policymakers should be to make sure workers have the tools they need, and understand the pros and cons of their choices. Regulatory uncertainty should not prevent plan sponsors and plan fiduciaries from helping workers understand and utilize the robust lifetime income solutions that insurers, mutual funds, advisers and banks have developed.