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STATEMENT FOR THE RECORD

FROM

THE AMERICAN COUNCIL OF LIFE INSURERS

BEFORE

THE 2012 ERISA ADVISORY COUNCIL

EXAMINING INCOME REPLACEMENT DURING RETIREMENT

IN A DEFINED CONTRIBUTION PLAN SYSTEM

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For a number of years, policy makers, academics, and others have been studying how to use retirement accounts to provide income in retirement. The Council issued reports focused on these topics in 2008 ("Spend Down Of Defined Contribution Assets At Retirement") and in 2005 ("Retirement Distributions & Options"). These issues were the subject of the "Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans" issued by Treasury and Department of Labor ("DOL") in February 2, 2010. We appreciate the Council's continued attention to this topic.

ACLI's response to DOL and Treasury's RFI discussed many of the questions raised in the Council's issue paper. We believe there are a number of suggestions that the Council could make to DOL that would increase the lifetime income education and options available to participants.

Simply put, life annuities address longevity risk. Annuities are the only commercial source of income payments for life. The need for lifetime income is well understood. Annuities can help insure that individuals have adequate income at advanced ages, even if they live to age 100 and beyond. They provide a source of income that cannot be outlived. Annuities provide insurance against a drop in standard of living and thus are an important tool for retirement planning. Through risk pooling, insurers can offer annuities with potentially higher sustainable level of income than can be achieved with other financial assets.

Forms or Types of Annuity Contracts

There are a variety of guaranteed lifetime income products which are generally available through employer plans, through IRAs, or on a non-qualified basis. The following is a brief description of the types of annuity contracts and guaranteed lifetime income benefits that exist today.

Annuity and other guaranteed lifetime income forms or features may provide for payments that are a "fixed" set amount or that vary on the basis of underlying investment options. They may an "In-Plan Annuity" available to plan participants through an employer plan or an "Out-of-Plan Annuity" purchased by individuals through an IRA or on a non-qualified individual basis. Annuity forms include:

- **Immediate Payout ("Income") Annuity** - For a sum, the insurer makes periodic payments determined by the price or purchase rate for life or a set number of years, e.g. a "SPIA" or single premium immediate annuity.
- **Deferred Payout ("Income") Annuity** - A payout annuity with a delayed annuity commencement date, e.g. at normal retirement. A "longevity annuity" or "longevity insurance" is a delayed payout annuity with payments commencing later in retirement, e.g. at age 85.
- **Incremental Purchase of Deferred Payout ("Income") Annuity** - An annuity or annuities purchased in increments by monthly payroll deductions, for example.
- **Deferred Accumulation Annuity** - An annuity purchased with a single premium or multiple periodic premiums, invested on a fixed, variable or combination basis for accumulation until distribution. In addition to single sum or period withdrawals, the annuity contract provides the owner the right

to elect to convert some or all of the accumulated balance into annuity payments at the annuity commencement date at no less than the purchase rate guarantee.

- **Guaranteed Living Benefits** - Features under a deferred accumulation annuity contract that provide protection during the life of the owner against investment risk by guarantee of the level of annuity payments and/or withdrawal amounts. Examples:

  - *Guaranteed Lifetime Withdrawal Benefit* ("GLWB"), a benefit that allows for guaranteed withdrawals from the owner's account without having to annuitize the contract (prior to the annuity commencement date). The amount that can be withdrawn under a GLWB is based on a percentage of the 'benefit base'.

  - *Guaranteed Minimum Income Benefit* ("GMIB"), a guarantee that under certain conditions the owner may annuitize (at the annuity commencement date) the contract based on the greater of (1) the actual account value at standard annuity payout rates or (2) a 'benefit base' at conservative GMIB payout rates guaranteed under the rider.

Optional life contingent benefits and features include:

- **Single Life** - Periodic payments made only for the life of the annuitant. Of all of the various life annuity options and features, a single life annuity provides the highest amount of guaranteed payments at commencement. Unlike other options, a "straight" single life annuity offers no death benefit.

- **Joint and Last Survivor** - Periodic payments for the joint lives of the annuitants. Payments to the surviving annuitant may be, for example, 50%, 75% or 100% of the original initial payment amount depending upon the terms of the contract.

- **Period Certain** - Periodic payments for the life of the annuitant and continued payments to a beneficiary during the period certain, i.e., during the 5 year, 10 year or other fixed length period set in the contract that commences with the first payment made to the annuitant.

- **Cash Refund** - Periodic payments for the life of the annuitant and a benefit payable to a beneficiary upon death equal to the premium(s) paid less payments made to the annuitant.

- **Inflation Protection** - Annuity payments increase annually according to a set percentage or formula.

- **Commutation or Cancelation Right** - Permits the annuitant to cancel the annuity contract after the annuity commencement date during a set period of time and receive premium(s) paid less payments made to the annuitant.

In-Plan Annuity Innovations

Incrementally purchased annuities and guaranteed living benefits. These forms of annuity benefits are now being offered in retirement plans. Innovations are underway to incorporate within target date funds income solutions such as deferred fixed income annuities and a range of guaranteed living benefits.

In-Plan Annuity Impediments

When considering potential plan designs, employers commonly weigh the advantages and disadvantages of annuities. In general, the employer's overriding goal is to sponsor a plan that will advance its business objectives of attracting and retaining a skilled and qualified workforce by providing employees with means to save and attain a secure retirement through participation in the plan. Employers tend to weigh the advantages of a particular design feature against the potential burdens that accompany that feature. In the case of guaranteed lifetime income, many employers may not have enough knowledge or experience to understand the benefits.

Many of the concerns that currently impede employer selection of lifetime income options are a by-product of perceived fiduciary risk and administrative burden. Below, we will discuss a number of smart, sensible and effective policy measures that, if implemented, may reduce the perceived and actual costs and burdens in employer considerations of lifetime income options.

Employer Fiduciary Liability. It is difficult to overstate the high level of concern about fiduciary liability that currently impedes the selection of lifetime income options. The DOL's 2008 clarification that the safest available annuity standard does not apply to defined contribution plans was an extremely positive first step to reducing the magnitude of the fiduciary liability impediment, but additional guidance is needed.

The DOL should adopt rules and regulations to make the duties of employers in selecting providers of guaranteed lifetime income products similar to employers' duties in selecting providers of life insurance or disability insurance or other financial protection products.

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 hard to use the safe harbor and is not a requirement of selection of other financial protection products. ACLI 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.

The safe harbor should continue to contain the following rules, i.e., that the fiduciary:

- engage in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;

- appropriately consider and conclude, at the time of the selection, that the cost (including fees and commissions) of the annuity contract is reasonable in relation to the benefits and administrative services to be provided under such contract; and

- if necessary, consult with an appropriate expert or experts for purposes of compliance with the safe harbor provisions.

Instead of a determination about the financial ability to make all future payments, the safe harbor should require the fiduciary to give consideration to the financial strength and other "quality" aspects of the provider.

We know that the DOL has already given serious thought to this issue. As you consider recommending such changes, it is important to recognize the important role of state insurance departments in oversight of life insurance companies, including the imposition of NAIC uniform rules for the establishment of reserves, the valuation of assets and liabilities, risk-based capital requirements, and required capital. The primary functions of the state insurance departments are to protect policyholders and oversee company solvency. The insurance departments conduct routine reviews of the financial strength of each insurer and its ability to meet its commitments. This system of regulation is a factor in the consideration of the quality of a provider.

Annuity Administration Relief. The qualified joint and survivor annuity ("QJSA") rules add a layer of administrative complexity and attendant liabilities that employers can simply avoid by excluding annuities from their plans, and most do. In addition, current law requires that QJSA rules be administered with paper documents.

We ask the Council to support modifications to ERISA to permit plan sponsors to shift the responsibility (and attendant liability) for QJSA administration to qualified lifetime income administrators. The ability to shift annuity administration and potential liabilities to another party would make annuity options more attractive to plan sponsors and could result in a significantly wider availability of such annuity payment options under defined contribution plans. Insurance companies have experience in managing annuity administration and risk. Of course, the selection of an annuity administrator would remain a fiduciary act.

At the same time, the use of electronic means of QJSA administration is needed to promote efficiencies and reduce costs. Electronic alternatives to paper that simplify and lower the cost of administration should be considered. Electronic administration is commonplace in all aspects of modern life including the management of individual financial affairs from banking to tax filings. Any party responsible for QJSA administration and its attendant liabilities is sufficiently motivated to utilize effective electronic security processes to safeguard participant and spousal rights.

Portability. Employers may be concerned about the portability of lifetime income options, such as guaranteed living benefits and annuities. The termination of a plan's annuity contract may lead to the loss of access on the part of plan participants to the contract's guaranteed lifetime benefits. Participants need a workable means to maintain access to these benefits. Currently, such means are available to those participants that are eligible for a distribution from the plan.

We ask the Council to supports legislation and regulation that would permit the distribution of that portion of the participant's accrued benefit insured under an insurance contract upon contract discontinuance. The rules should permit this distribution to be made via a qualified plan distributed annuity contract or a direct rollover to an IRA or other eligible retirement plan. Either approach would permit a participant to continue insurance coverage.

Education

To make an informed decision regarding whether to select a guaranteed lifetime income option, participants need a basic understanding of the options available to them and the advantages and disadvantages of each. Currently very few participants have even a basic understanding of guaranteed lifetime income options and how they work. Even plans that offer a guaranteed lifetime income option provide little education about it, if any. The best way to assist those in the process of planning their retirement is to ensure they have information about guaranteed lifetime income solutions such as an illustration of how the account balance translates into guaranteed lifetime income, education necessary to use such solutions and resources available to assist them with questions and planning. Many providers are able to assist employers by making this type of information available to participants using a combination of different mediums including paper, e-mail, CD, DVD, internet and call center.

A number of factors, including the current economic situation and lengthening life spans, have made it more important than ever to encourage employers to provide information about guaranteed lifetime income options and to educate their participants on all of the options available to them, both inside and outside of the retirement program, as well as the merits and limitations of both guaranteed lifetime income options and other approaches.

Many employers are still hesitant to provide information about guaranteed lifetime income due to potential fiduciary liability. Clear guidance for employers regarding educating participants about lifetime income or other arrangements designed to provide a stream of income after retirement would likely encourage employers to provide the resources necessary for participants to make these decisions. Fiduciaries should be afforded protection for the dissemination of information on plan distribution options as well as information on other retirement options including options outside of the plan (information regarding the fact that participants may purchase lifetime income options from another provider via a rollover to an IRA or with the proceeds of a lump sum). We agree with the recommendations made in both the 2007 and 2008 ERISA Advisory Council reports to expand Interpretive Bulletin 96-1 to explicitly cover education regarding "decumulation" strategies such as lifetime income options. A model notice may prove to be helpful to plan sponsors.

DOL guidance allows for the use of plan assets to pay for participant investment education related to retirement income. DOL should clarify that plan assets may be used to educate participants about lifetime income options including those typically available outside of the plan. Without this clarification, plan sponsors, who are in the best position to ensure that participants receive this information, may hesitate to do so and plan service providers may be reluctant to include education on lifetime income as part of their service models.

Illustration. Current law and common plan design encourage participants to consider their account balances as single sums available for payment upon retirement. This can and often does create a false sense of wealth. ACLI supports changes to the ERISA plan benefit statement rules to include an illustration of the participant's account balance as a guaranteed monthly income payment for life commencing at normal retirement. The DOL is currently working on proposed regulations on the participant benefit statement rules, and we understand that they are planning to include provisions regarding inclusion of the illustration on the statement. We would encourage DOL to include this as a requirement for all defined contribution benefit statements.

Illustrations would be based on either a plan's existing guaranteed lifetime income product or a table prescribed by the Department. The regulations should explicitly state that plans and plan fiduciaries are not liable for payments in the amount illustrated under these rules. The DOL should provide model language that plans may include on statements to make clear that the payment amount is illustrative.

Illustrations will help educate participants as to their account values' retirement income potential. This information will assist them in evaluating such factors as their income need, savings adequacy, and the amount of income devoted to retirement savings. It reframes the defined contribution plan as a retirement plan that can generate retirement income and not just a capital accumulation or savings plan. [Our survey shows that participants want this information]

Target Date Fund Education. To put lifetime income options vis-à-vis other income options in perspective today, participants need to be able to weigh the benefits and disadvantages of each option. In November 2010, the DOL issued a proposed regulation to provide additional guidance on disclosures that should be made with regard to target date funds. The DOL recently reopened the comment period on this proposed rule because of a report recently released by SEC on the results of investor testing of comprehension and communication of issues relating to TDFs. The report states that only 35% of the respondents correctly indicated that a TDF does not provide guaranteed income.

Target date funds with guaranteed lifetime income solutions are a new innovation. It is important that participants understand when an investment or "income solution" provides no lifetime guarantee. Participants should also understand the need to manage their account balance and to understand factors such as investment risk and longevity risk inherent under "sustainable withdrawal rates."

<u>Annuity Pricing</u>

Fixed immediate payout annuities. When discussing immediate annuities from defined contribution plans, we often hear that the "fees" for annuities are too high. This indicates a misunderstanding about how immediate annuities are priced. All financial products have costs associated with them and annuities are no different. However, because fixed immediate annuities do not work like other financial products such as mutual funds, the amount paid for the product is determined in a very different way.

The price of the immediate annuity is the single premium paid to the insurance company. The purchaser makes a one-time payment, and in return for this purchase payment will receive a stream of equal monthly annuity payments (payments may also be quarterly or annual). The annuity payments must begin within a year, but typically begin within a month of purchase (when exactly payments commence is at the owner's discretion, as long as it is within one year) and are guaranteed to last until the purchaser's death. For example, a purchase payment of $50,000 might provide annual annuity payments of $3,600 (or monthly payments of $300). The amount of the monthly (or quarterly or annual) annuity payment depends on the amount of money paid by the purchaser and the price of the annuity, as described below. This is similar to a life insurance contract, in which a purchaser can pay a single premium in return for the right to receive payment upon death. Insurance companies take into account a number of factors in setting the price for annuity and life insurance contracts. The following are examples of these factors:

- Mortality rates – The insurance company will develop estimated mortality rates, and will consider not only how long a person is expected to live but also the likelihood of that person living much shorter or longer than expected and a person's age at the time that payments begin.

- Interest rates - Generally, when interest rates are lower, the annuity price goes up, and when interest rates are higher, the annuity price goes down. In simple terms, this is because the insurer can expect to earn more or less on its investment of the purchase payments. In today's economy, because interest rates are currently low, annuity purchase prices for a particular payment stream are currently higher than they would be if interest rates were higher (e.g., "higher" means that for a given purchase amount, the monthly annuity payments you receive will be smaller).

- Present value – The insurance company will calculate the estimated present value of the stream of payments – this requires making assumptions regarding both mortality and interest rates.

- Expense of providing the annuity – The insurance company will consider the costs of providing the annuity – this includes overhead, making the actuarial calculations, issuing and mailing the monthly checks, investment functions, etc.

- Capital cost – The insurance company must consider the cost of the capital needed to support the insurance company's obligations.

Each company has its own method/formula for setting prices. Not only may companies give different weights to these and other factors, but they will also calculate the factor in their own way. Companies may use different mortality estimates, different interest rate assumptions, and may have different approaches to calculating the present value of the annuity payments. Interest rate assumptions may also vary due to the composition of the company's general account investments – its weighting between long-term or short- term investments.

Insurers provide a guarantee that the payments will continue until the annuitant's death. If the annuity payments continue to the point in which they exceed the value of the purchase payment paid for the annuity, the insurer must continue to make the annuity payments, even though the payments exceed the premium. This risk is balanced by the fact that some annuitants may die much earlier than expected. Therefore, in setting the price, the insurance company must carefully balance the risk it is taking on and the revenue that it hopes to make. In estimating potential revenue, the insurer must estimate the income that it will earn on the purchase payments collected (generally, these payments are held in the insurer's general account, and invested in relatively conservative investments). The insurance company is taking on investment risk (risking that the investments may not earn as much as expected or may experience losses in the insurer's general account), mortality risk (risk that the purchasers/annuitants will live beyond their expected mortality) and an expense risk (risk that the expenses associated with running the annuity business will exceed what is expected).

Note that when we say that there are no fees for these immediate annuities, we are not suggesting that the product is free or that the insurer will not attempt to earn a profit on them. Rather, an estimate of profit is built into the purchase price. However, as explained above, unlike fees, ultimately, the profit (if any) on any single contract is not known until payments end.

Other Types of Annuities. There are many different types of annuities other than an immediate annuity, and the pricing method for each is different. In a deferred annuity, as the name suggests, payments are made now for a stream of payments that will commence in the future. There is an investment phase (in which the purchase payments are invested and earnings accumulate) followed by an income phase (in which the account is converted into a stream of income). In a fixed deferred annuity, the investment phase consists of a fixed return on the account. In a variable deferred annuity, the account can be invested in a range of equity and fixed investments as selected by the purchaser, and therefore the account will fluctuate based on the underlying investments. In other words, in a variable annuity, the investment risk is retained by the purchaser (during the investment phase), and the insurer keeps the interest and mortality risk because it has guaranteed the annuity purchase rate. The investments of this type of annuity are held in a separate account of the insurance company and purchased by investors on a unitized basis. Unitization is a method of allocating the various investments in the separate account across multiple subaccounts, so when a unit is purchased, the unit represents an undivided interest in the overall portfolio. Once the income phase starts in both a fixed or variable annuity, the stream of payments is based on the account balance and the conversion is generally subject to a minimum rate guarantee stated in the contract (determined at the time of purchase, not at the time the annuity payments begin). The annuity may be cashed out prior to the commencement of the income phase.

For a fixed deferred annuity, the pricing is very similar to the immediate annuity and the same factors are used. During the investment phase, there is no fee as there is in a mutual fund, but rather it functions more like a banking CD. The insurer sets the rate of return, based on assumptions it makes, and factoring in an amount of profit it hopes to make. However, because the rate is guaranteed to the investor, the insurer may or may not profit from the contract, based on the actual performance of the investments in the insurer's general account. If you withdraw money from an annuity, there may be a surrender fee or withdrawal charge (generally, this charge is so the insurance company can recoup expenses such as taxes, commission, and operational overhead that could not be realized because the money was not left on deposit long enough). Other fees also may apply, such as transaction, market value adjustment, and contract fees.

The pricing of the investment phase of the variable deferred annuity is similar to a mutual fund. There is generally an asset-based charge for the management and operating expenses of the fund (these charges pay for everything from the fund manager's salary to brokerage commissions) and there may or may not be other charges associated with the fund, depending on the contract and its insurance features. Variable annuities usually have more features and they have, therefore, more complex and higher fees than fixed annuities. For example, variable annuity fees may include an annual contract charge that covers administrative expenses and a basic death benefit or guaranteed withdrawal benefit. When it comes to the conversion of the account to a stream of payments, the pricing works like the deferred fixed annuity and is based on the factors described earlier.

State Regulation

Life insurance companies are subject to state regulation requiring the establishment of reserves, the valuation of assets and liabilities, risk-based capital requirements, surplus rules, and presale approval of insurance contracts (with actuarial justification).

State insurance departments provide regulatory oversight of the life insurance industry. These insurance regulators routinely gauge the financial strength of insurers and conduct complex analysis to determine an insurer's ability to meet its future commitments under its lifetime income products. This is much more than can be expected of any employer or any expert a plan fiduciary may retain at significant cost (which itself is a deterrent to offering these types of options). The insurance regulators have access to information that is not available to employers or their advisors. This information includes quarterly reviews of the financial statements of insurance companies domiciled and/or authorized to do business in their states, and the ability to gain the attention of senior management to address concerns about the insurer's financial situation. The following is a brief overview of the various layers of state regulation that exist to protect consumers against insurance company failures.

State insurance regulators impose extensive scrutiny on insurance companies in their licensing and approval processes. Insurers are subject to detailed rules related to the establishment of reserves, valuation of assets and liabilities, risk-based capital requirements, surplus rules, requirements that products (contracts) must be approved prior to sale (with actuarial justification), and restrictions on dividends to holding companies apply.

When an insurance company is found to be financially unstable, the insurance department in its home state will generally step in and take control of the company (known as the "receivership process") and attempt to improve the company's financial status (known as "rehabilitation"). States have broad powers to intervene and take over insurers early in any developing problem/downward spiral to prevent insolvency or liquidation. This broad rehabilitation authority enables the state to fully protect the insurer's financial soundness, and thus, policyholder interests, are fully protected.

If a company's financial difficulties are too great to overcome, the state can declare the company insolvent, and the receivership process moves into the next stage, known as "liquidation", in which the receiver (usually, the commissioner or someone appointed by the commissioner) attempts to maximize the company's assets to pay off as many creditors as possible, including policyholders. In addition, the state may seek to have one or more other insurance companies take over the struggling insurer's "book of business" and agree to pay policyholders in full. In some cases, the state may provide financial support to the assuming insurers.

As policyholders, annuity contract holders (including holders of group annuity contracts issued to qualified plans and their participants) are given a priority status over all general creditors and many otherwise protected parties (i.e., employee claims). Few if any claims are superior to the policyholder claims (generally only the state's administrative costs and any guaranty association costs). Life insurer creditors seldom have extensive security interests, so policyholders have access to virtually all of the insurer's general assets.

As a result of this protective regulatory process, the number and size of annuity carriers that have gone into liquidation is quite small, and account policyholders have generally received the full contractual benefits guaranteed under their contracts.

In the unlikely event of an insolvency/liquidation, the state guaranty association coverage will protect policyholders, including those holding annuity obligations. While the state guaranty fund protections are limited, there has been a strong tendency to increase these limits. Coverage ranges from $100,000 to $500,000 of the contract's present value with most states at or above $200,000. As a result, in the unlikely event of an insolvency and liquidation, the majority of plan participants would be fully protected.

<u>Conclusion</u>

ACLI encourages the Council to recommend that DOL take steps described above that would make it easier for employers to offer lifetime income products and to provide education to employees on all areas of decumulation.