2012 ERISA ADVISORY COUNCIL

Examining Income Replacement During Retirement in a Defined Contribution Plan System

Statement Prepared by

Bruce Ashton

DrinkerBiddle

Drinker Biddle & Reath LLP
1800 Century Park East, Suite 1400
Los Angeles, California 90067
(310) 203-4000
bruce.ashton@dbr.com
www.drinkerbiddle.com

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INTRODUCTION[1]

We applaud the Advisory Council's examination of income replacement in a predominantly defined contribution (DC) plan retirement system. Indeed, this could be the most critical retirement planning issue currently facing American workers and their employers.

In today's DC plan environment, we believe that many participants misperceive the nature of their plan. Many appear to view the plan as a source of retirement savings – that is, a vehicle for wealth accumulation – rather than retirement income. Coupled with the shift away from defined benefit pension plans,[2] this misperception may leave many retirees with inadequate resources in retirement. Put simply, when people retire, their monthly income stops but their monthly expenses do not. Understanding how to address this fact is essential.

More and more workers will face significant risks in retirement, leading to what some have referred to as the post-retirement crisis[3] These risks include: a lack of understanding of the replacement income the retiree needs to preserve an adequate lifestyle; longevity risks, *i.e.*, the significant statistical probability that individuals will live longer in retirement than they expect; sequence-of-return risks, that is, the impact of investment market downturns at the "wrong" time; the lack of understanding about the appropriate rate at which retirement income can be withdrawn from a defined contribution account or IRA; inflation risk; and cognitive risk, *i.e.,* the loss of decision-making capacity as we age into our mid-80s and beyond.

Given these risks, we appreciate the opportunity to provide this input to the Council in examining the four critical issues outlined in its call for comments:

1. The challenges participants face in making their account balances in DC plans last for the length of their retirement years, including improved longevity.
2. Alternative options available to participants that would be helpful in their efforts to make their accumulated savings last over their retirement lives or the lives of their spouses.
3. The considerations and challenges plan sponsors encounter when making some alternative options available to plan participants.
4. The considerations and challenges faced by plan sponsors in providing education outreach for participants regarding the available income replacement options.

In considering these issues, the Council posed a series of questions for witnesses at today's hearing. Before considering these questions, we believe it is important to further set the stage, to understand why the issues being raised today are so important. To do so, we focus on the challenges facing participants.

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[1] Fred Reish, Joan Neri and Bradford Campbell have materially assisted in the preparation of these comments, but the author takes full responsibility for the content.

[2] "Defined contribution plans dominate the retirement plan scene today." *LaRue v. DeWolff, Boberg & Associates*, 128 S.Ct. 1020, 1025 (2008).

[3] *See* Allianz Response to the Department of Treasury/Department of Labor RFI on retirement income issues, at page 4.

CHALLENGES FACING PARTICIPANTS

A retirement system based on individual savings and investment decision-making – where the individual participant funds a major part of his or her own retirement (though plan sponsors often help through matching or profit sharing contributions) – leaves participants vulnerable. First, they must decide how much of their pay they can set aside for deferral into the plan. Second, despite a probable lack of education, they must decide how to invest the funds so that their accounts grow over time. Finally, again with little or no education, at retirement, they must decide how to spend the money, that is, how to make it last for the rest of their lives.

In the Introduction, we noted a number of factors that impact the "how-to-spend-it" issue. Each of these alone increases a participant's risk of running out of funds, but taken together they compound the problem. The following are the principal issues:

- *Replacement income*: We believe that most participants fail to understand how much replacement income they will actually need, probably in the range of 75% to 85% of their final pay to maintain their pre-retirement standard of living.[4] A component of this issue is that the failure to understand how much must be deferred in order to achieve that level of monthly retirement income.

- *Longevity*: We believe that few participants understand how long they can expect to live after retirement – and thus how much money they will need for retirement. Statistics show that there is a 50% probability that, for a married couple aged 65, at least one spouse will live 25 years and a 25% probability that one will be live at least 30 years.[5] In other words, there is a significant probability that retirement funds will need to last for as much as 30 years, a sufficiently high probability that participants cannot afford to ignore it.

- *Sequence-of-return risks*: Down markets at or soon after retirement can have a devastating effect on retirement savings and thus on retirement income. One challenge facing retirees – and their employers – is finding investments that effectively eliminate the sequence-of-return risk.

- *Withdrawal rate issue:* Even if the longevity and replacement income issues are well understood, retirees still need to understand how quickly they can expect to withdraw retirement savings and still expect to have enough to last the rest of their lives. Studies have shown that a withdrawal rate of about 4%, inflation adjusted, has a 90% probability of lasting 30 years.[6] Yet this is much lower than most people think.[7] Higher withdrawal

4 *See,* for example, Aon Consulting, "Aon Consulting/Georgia State 2008 University Replacement Ratio Study."

5 Reish, Fred, Ashton, Bruce and Byrnes, Pat, "The Problem with Living Too Long," Institutional Retirement Income Council (2010), http://www.iricouncil.org/docs/The%20Problem%20With%20Living%20Too%20Long.pdf.

6 William P. Bengen, "Determining Withdrawal Rates Using Historical Data," *Journal of Financial Planning,* October 1994, pages 171-180.

7 One recent study showed that more than 33% of those interviewed had no idea how much they could safely withdraw and roughly 25% expected to be able to withdraw more than 10% of their retirement savings each year*See,*

– or payment – rates are possible in some products, of course, but it is essential that participants be educated on this issue.

- *Inflation risk*. This is an ever-constant danger for those living on a relatively fixed sum of money – as retirees from DC plans are forced to do. Social Security currently has a built-in inflation adjustment factor, but DC plans and rollover IRAs do not, so it is important to seek out investments that offer such protection or a "proxy" for it.

- *Cognitive risk*: This may be the least understood risk of all. Recent studies have shown that as people age, they experience some degree of mental deterioration that affects their ability to make sound decisions, such as those involving investments and distributions,[8] and the deterioration becomes acute past age 80. Participants need to understand this risk so that at or near retirement, they can make decisions that reduce – or eliminate -- the need to revisit investment and distribution decisions at a time when they are less capable of doing so.

QUESTIONS FOR WITNESSES

1. *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?*

Before considering the options available to participants, we suggest that the question be re-focused somewhat. The question references the "elected period designated by the participant." Instead, we believe the question should focus on securing a stream of income designed to last for the participant's lifetime. Some products, such as traditional annuities, may provide a guaranteed payout for a specified period (most often, 10 years), but unless they also offer a lifetime guarantee, they do not fully address the retirement risks discussed above.

A number of insurance and investment products in the marketplace are designed – or at least intended – to provide lifetime income. These are described briefly below, with an indication of how well, in our view, each addresses the retirement income challenges described earlier. We assume in this discussion that each is offered inside the plan and that the benefit accrues over time.

It is important to recognize that while these products may, to a greater or less degree, deal with the retirement income issue, none can solve the most critical issue, benefit adequacy. By

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Lee Barney, "American All Over the Map on Retirement Drawdown Rates," Money Management Executive (October 13, 2011).

8 *See*, David Laibson, "Cognitive Impairment: Precipitous Declines in Cognition Can Set the Stage for Poor Decisions About Retirement Finances," which appears in the Allianz RFI Response, http://www.dol.gov/ebsa/pdf/1210-AB33-617.pdf. Professor Laibson's research showed a significant decrease in "analytic cognitive functioning" as people age and that older adults make financial mistakes. In effect, older people are less able to make cogent financial decisions, to analyze financial data and properly consider risks, which suggests that they are less able to make sound decisions about their financial security once they reach their 80s…a point when they may live another 10 or more years.

benefit adequacy, we mean the accumulation of sufficient retirement savings to provide replacement income adequate to sustain a retiree's lifestyle. Having "enough" means deferring "enough" (plus employer contributions), and the solution to that may only be through participant education or, potentially, through automatic enrollment and escalation of deferral rates.

Another "inadequacy" of all of the retirement income products is that they are dependent (to a substantial degree, if not entirely) on the economic viability of the issuer of the product. That is, will the issuer of the product be around when the participant needs the funds? In this sense, all of these vehicles present a risk to the participant and a potential barrier for selection by the employer, which bears the fiduciary responsibility for picking the vehicle. Concern with fiduciary liability may prevent many employers from adopting an in-plan solution. This is discussed further in response to Question 3.

Traditional annuities: Annuity contracts offer advantages and disadvantages. The principal advantage of annuity contracts is the guarantee of payments for life or for a guaranteed period. They often provide larger monthly payments than other products. The principal disadvantage (or at least perceived disadvantage) is that the participant relinquishes access to his or her retirement savings during life in return for the guaranteed payments. This means that once a contract is annuitized, there may be no residual value that can be passed on to the participant's heirs, unless a joint and survivor annuity has been selected or the annuity is guaranteed for a specified period. In our experience, many participants are reluctant to annuitize their retirement benefits in light of this.

A traditional fixed annuity addresses a number of the retiree risks: longevity risk by offering payments for life; sequence-of-return risk by offering a guaranteed payment; and cognitive risk by eliminating decisions by the annuitant; and it solves the withdrawal rate question by providing a fixed guaranteed payment. Annuities may also deal with the inflation risk by offering a cost-of-living adjustment (in return for lower payouts) or increased payments based on the return the insurance company is able to achieve on its investments.

Guaranteed minimum withdrawal benefit features: Since these products are newer to the marketplace, we have provided a description of how they work. We refer to a guaranteed minimum withdrawal benefit ("GMWB") product as a "feature" because it is a guarantee by an insurance company that wraps around or is coupled with an investment product, often a balanced or target date fund. When a participant selects a GMWB feature, the participant elects to invest some portion or all of his or her deferrals (and employer contributions) in the related fund. In addition to the investment related costs, the participant also pays a "premium" to the insurance company in exchange for the guarantee. The guarantee promises to pay the participant a specified percentage of the "benefit base" (usually the high water mark of the account balance) if the account balance runs out during the retiree's life. The withdrawal rate, if withdrawals begin at age 65, is typically 5% of the benefit base or 4.5% if the participant selects a joint and survivor guarantee; if withdrawals begin at age 70, the rates typically go to 6% and 5.5%. Withdrawals in excess of these amounts are permitted but decrease the benefit base.

Under a GMWB feature, the insurance company makes payments out of its funds only if the retiree's funds run out. Before that happens, the retiree is taking monthly income out of his or her own investments. And if the retiree's funds do not run out, there are assets left over to be paid to his or her heirs.

The latter is a perceived advantage of a GMWB feature, i.e., that the retiree retains control over his account. Other perceived advantages are that the participant (in a number of the products) can take advantage of investment appreciation while being protected from downside risk, and has a guaranteed stream of retirement income payments so long as the retiree observes the withdrawal rate restriction. A possible disadvantage is that the guaranteed annual withdrawals after retirement may be less than those historically available under the traditional annuity.

A GMWB feature addresses several of the retiree risks: longevity risk through the guarantee of payments after the retiree's funds run out; sequence-of-return risk through the downside protection of the benefit base; and to some degree, the withdrawal rate question, although the GMWB requires that the retiree exercise constraint over withdrawals of funds. Except to the extent the GMWB permits the retiree to control the rate of withdrawal of his or her own funds, the GMWB also addresses the cognitive risk in that the retiree has no new decisions to make in later years, though this does leave the retiree vulnerable to some degree. Finally, in products that permit the benefit base to increase post-retirement, a GMWB may also deal with the inflation risk in an indirect sense through the investment returns on the account balance.

Longevity insurance: Longevity insurance refers to deferred annuities that start payments to the annuitant when he reaches a specified age, often age 85. The perceived advantage of longevity insurance is that it offers a "safety net" to address longevity risk and the risk that the retiree will spend down his retirement savings. That is, the retiree will still have a source of income if he lives long enough. But this is also a potential disadvantage in that the retiree pays a premium for a product that he or she may never be able to take advantage of by not living long enough.

These products address the longevity risk, in that they provide income at a point when a retiree may be running out of other retirement savings. Once the payments start, they also eliminate the sequence-of-return, cognitive and withdrawal rate risks. They also provide lifetime income once payments begin. They do not, however, typically address the inflation risk, so that a payment purchased today may have lost a significant amount of its purchasing power 15 or 20 years later.

Managed payout and retirement income mutual funds: Managed payout funds are mutual funds that are designed to provide a steady stream of retirement income while still allowing retirees access to their money during their lifetime and the ability to pass it onto their heirs upon death. Because these are mutual funds and not insurance products, they cannot offer a guarantee of future payments, though the products are intended to make periodic distributions at a specified annual percentage of principal.

Managed payout funds come in two forms, those that offer a defined term or payout period and those that offer a defined payout amount:

- In defined term funds, the fund establishes a set time period over which payments based on the invested principal and investment returns will be made. Because this is not an insurance product, the payments are not guaranteed to last for the intended payout period and may fluctuate over time, depending on market gains or losses. In these funds, retirees remain subject to the sequence-of-return risk and may not have enough to live on if losses deplete the fund too quickly. In addition, at the end of the defined term, periodic distributions will cease and the net asset value of the fund, if any, will be returned to the retiree. This could occur at a point when the retiree is especially vulnerable to the cognitive risk.

- Defined payout funds provide a specified payment or percentage of the invested capital. Generally, the target distribution amount is set annually based on investment returns, since the funds are designed (and managed) to make payments only out of earnings, though the fund manager retains the discretion to pay out principal in order to meet the defined or target payout amount. In addition, the time period over which the payments will be made may be extended or shortened, depending on investment gains or losses. As a result, retirees remain subject to the longevity and sequence-of-return risks.

A disadvantage of these products is that, like any fund, the ability to meet the stated distribution objectives depends on investment performance. Even those that are designed to make distributions only out of earnings may be forced to deplete their investment principal if the investments under-perform the target.

Unless the securities markets perform as anticipated during the payout period, retirees remain subject to the longevity, sequence-of-return, inflation and cognitive risks, and only the defined payout fund addresses the withdrawal rate risk (by providing for a specified payment each month) so long as the invested funds are not exhausted. This downside risk is offset to some degree by the fact that the funds tend to have a lower cost because there is no guarantee element built into the product.

Managed retirement income accounts: Unlike the annuities and managed payout funds, managed retirement income accounts are a service rather than a product. That is, a professional money manager undertakes to manage the account of the participant, often using the investment alternatives available in the DC plan, with the investment objective being capital preservation and income. An added feature of the service is overseeing the monthly payout of benefits. Some of the services also suggest that the retiree purchase longevity insurance.

Though these arrangements are professionally managed, the participant retains control over his account and can begin or cease payouts at any time and take additional withdrawals of funds if desired. This type of service offers monthly payouts, but like the managed payout mutual funds, they are not guaranteed, and do not solve the longevity, sequence-of-return, inflation or cognitive risks unless the securities markets perform well during the payout period (except to the extent the retiree purchases longevity insurance).

Target date funds: While target date funds offer advantages during the accumulation phase, they do little to address retirement risks during the decumulation phase, even if they are so-called "through" funds in which the glide path becomes the most conservative at a point after retirement. They do not solve the longevity, sequence of return, inflation or cognitive risks, though they may minimize the sequence of return risk to the extent they are more heavily weighted towards fixed income investments in the post-retirement years.

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

Participants will have different considerations depending on their personal assets, family situation, income needs and other personal circumstances. Obviously, these will play a role in how a participant views his or her retirement savings and the importance of one or more of these income replacement options. Nevertheless, we submit that the following are issues that participants need to consider:

- *How long will the participant live after retirement?* Put another way, how long should the retiree plan on needing retirement income? Based on current longevity statistics, it appears that the prudent retiree should plan on 30 years in order to avoid running out of funds.

- *How much replacement income will the retiree need?* If the answer is $50,000 a year plus Social Security, the next consideration would be what withdrawal rate to use in achieving this amount. While this may seem counter-intuitive, we submit that a participant needs to "work backwards" in determining how much he or she needs to accumulate in retirement savings, and this depends on how the retiree will draw down the funds. This is because the payout or distribution rate of each replacement income option differs. For example:

    - If a retiree is prepared to exercise the self-discipline to withdraw funds from an IRA or other personal investments, studies have shown that a roughly 4% rate is appropriate to ensure that the funds last for 30 years. To have a $50,000 annual retirement income, the participant must accumulate $1,250,000.
    - GMWBs provide for a 4-1/2% to 5% withdrawal rate. Using the 5% rate for the sake of simplicity, the retiree would need to accumulate $1,000,000 in retirement savings to feel comfortable with an annual withdrawal of $50,000.
    - Traditional annuities could range from 5-1/2% to 7% (depending on the interest rate environment at the time the annuity is purchased). If we assume a 6% payout rate, this dictates slightly under $850,000 in retirement savings to have a $50,000 annual income.

  Knowing the payout or withdrawal rate, then, instructs the participant on how much he or she needs to accumulate. Coupled with the participant's savings time horizon can be used to back into assumptions about deferral rates. A 25 year old with a 40+ year accumulation period could realistically assume she will achieve a $1,250,000 retirement savings balance. A 45 year old, on the other hand, may need to consider that he can realistically only save $850,000 and might need to consider deferring retirement to age 70 in order to do so (which would reduce the savings amount even further). The point is that by determining the desired replacement income amount, the participant who is armed with knowledge about payout or withdrawal rates of the various vehicles can then determine how much to save out of each paycheck in order to achieve the retirement income goal.

- *How much assurance does the participant want/need that she won't run out of funds?* If a participant's principal concern is to ensure that she will never run out of funds in retirement, she will probably want to consider an insurance product, such as an annuity or GMWB. And this, then, will dictate her savings rate, for the reasons discussed above. If, on the other hand, the participant is a relatively sophisticated investor who is comfortable with handling his financial affairs, he may chose to invest his retirement savings on his own (possibly with the help of a financial professional) and not incur the additional cost of a guaranteed or other professionally managed vehicle. For this participant, longevity insurance might be a viable option to help address the longevity and cognitive risks.

- *What is the cost of the option?* To make a reasoned decision, the participant will need to be aware of what the alternative will cost in relation to the benefit it offers. For example, is the premium paid for a GMWB worth the guarantee of the benefit base and lifetime income after retirement? Clearly, to make this decision, participants will need to be informed and be provided with an explanation of the "pros and cons" of the vehicle. (The analogy that comes to mind is the disclosure requirements of the federal securities laws – though on a much simplified level – in which those offering securities are required to explain what it is the investor is getting and the risk factors associated with it.)

- *Is the option portable?* In essence, the consideration here is what happens when the participant retires or otherwise terminates employment. Since most plans provide for a cash lump sum distribution, rather than a distribution in kind, the participant may not be able to retain ownership of an option acquired while in the plan. So a key question is how a participant takes the replacement income option with him to his next job or his IRA. Some providers have created a parallel investment with the same or very similar pricing for the IRA market, so that a rollover from the employer plan to the IRA will be essentially seamless. In some cases, providers are working on solutions that will enable a participant to retain an option acquired from one provider even if she is a participant in a plan with another provider.

Perhaps the biggest consideration for participants is whether they feel they know enough to make decisions about their retirement income needs. We are aware of studies that suggest most participants do not feel well-equipped in this area. This suggests two alternatives. One is that employers, the financial services industry and governmental agencies should be encouraged to begin enhanced education efforts to ensure that employees understand the risks they will face in retirement and the products or services available to assist them in handling these risks. One such effort, we submit, would be to encourage the use of retirement income projections on quarterly benefit statements (which we understand the Department is actively considering).

The second alternative is to encourage employers to provide retirement income solutions for participants that will substantially assist participants in achieving adequate retirement income by reducing the risks and potential burdens of providing such a solution.

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

The overriding risk of plan sponsors is the fiduciary obligation surrounding the selection of a retirement income vehicle and the provider of that vehicle. To make the risk more concrete, consider the following:

- How can a fiduciary select an option today that participants may not need for many years and that may need to provide payments to the participant even further out into the future?

- What if the fiduciaries select a product and provider, some participants invest in that product and then the fiduciaries decide to replace the provider? This is one aspect of the "portability" problem.

- Can the fiduciaries select a single product, recognizing that a "one-size-fits-all" approach may not work for a diverse workforce?

Minimizing the risk will necessarily require regulatory intervention. The Department of Labor has sought to address this in the DC plan environment, at least in part, by adopting a safe harbor regulation for the selection of an annuity provider. The final regulation, effective December 8, 2008, "… establishes a safe harbor for satisfying the fiduciary duties under [the prudent man rule of ERISA] in selecting an annuity provider and contract for benefit distributions from an individual account plan."[9] The regulation makes clear that it is *not* the only means by which fiduciaries are able to satisfy their fiduciary obligations in selecting an annuity provider, nor did it establish minimum standards. Rather, it sets out an optional means of satisfying this obligation.

The "safe harbor" establishes the following five steps:

1. Engage in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities.
2. Appropriately consider information to assess the ability of the annuity provider to make all future payments under the annuity contract.
3. Appropriately considers the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract.
4. 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 annuity contract is reasonable in relation to the benefits and services to be provided under the contract

[9] 29 C.F.R. §2550.404a-4

5. If necessary, consult with an appropriate expert or experts in connection with their consideration and conclusions.

We appreciate the Department's effort to create a safe harbor and recognize the difficulty in establishing a series of steps that fiduciaries can follow in order to properly perform their duties and at the same time avoid exposure to liability. And while the safe harbor regulation is an excellent summary of the fiduciary process, we submit that it does not provide sufficient detail to be a valuable tool for the average plan fiduciary. What information should be gathered to conduct an "objective, thorough and analytical search"? What information should be considered in assessing the ability of annuity provider to make future payments? What does "appropriately consider" mean?

We hasten to reiterate that these comments are not intended to be a criticism of the Department, for in attempting to come up with an alternative to this list of steps, we have encountered many of the concerns and obstacles that must have driven the Department. Nevertheless, we have developed a checklist that we submit could be used to enhance or expand the safe harbor. (In this connection, we refer you to a white paper, *Lifetime Income for Defined Contribution Plans: A Fiduciary Approach*, by Fred Reish, Bruce Ashton and Joseph Faucher, that contains a detailed discussion of the issues.)

Another concern for plan sponsors is that the annuity safe harbor regulation does not address other retirement income options. While the process outlined in the safe harbor regulation would presumably be the same for the selection of other products, it would be helpful if the Department were to issue guidance clarifying that this is the case. It would also be helpful for the Department to issue guidance addressing the "portability" issue raised in the second bullet point above.

4. 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 risk, and fee structure?

We have addressed key factors to be considered in the response to Question 3. That said, the question of portability, at both the plan level when the plan changes providers, and at the participant level, when a participant changes jobs or retires, is also an important issue for fiduciaries. Fee structure will necessarily be taken into account in the decision to select the product in the first place, so we do not single it out here.

The question of participant demand is an interesting one. In part, the question is whether this is a consideration that the fiduciaries should take into account. Put another way, should the demand for the product drive the availability of the product, or is it incumbent on the fiduciaries, the industry and regulators to provide sufficient information to drive the demand? We submit that participant demand is not a significant factor that fiduciaries should consider and that, instead, fiduciaries should take steps to create that demand among the participant population.

In our view, by themselves, a meaningful percentage of the participant population will likely not understand the need for or the desirability of having a retirement income option. This means that fiduciaries should provide education and information to foster the use of the products by participants. In saying "should," we do not necessarily mean that they be required by regulatory or legal mandate to do so. Rather, we submit that a regulatory environment should be created to promote education rather than requiring it.

The other key factors, as noted in the response to Question 3, are those relating to the selection of a provider of a long-term retirement income solution. That is, the fiduciaries should consider issues such as the following (which focus on the selection of an annuity provider, but similar concept should apply to the selection of the provider of other products):

The first step in the process would be to identify the companies that could fulfill the plan's needs, *i.e.*, that offer the products that the plan is looking to provide to the participants. One approach to make this determination is to use an RFP process; another might be to consult a financial adviser to help identify likely candidates.

The next step would be to perform the type of evaluation identified in the following checklist and to retain copies of the materials that are reviewed in due diligence files established for that purpose. (Fiduciaries may need to consider engaging a consultant to assist them.) Note that there may be factors not listed here that should be assessed, and the fiduciaries of each plan will need to consider the particular circumstances of the plan and its participants.

Further, similar to the DOL safe harbor regulation, we do not mean to suggest that a fiduciary that fails to follow these steps has breached his or her fiduciary duties. This checklist is not intended to define the fiduciary process for selecting an annuity provider but to provide a list of best practices that will assist fiduciaries in performing their duties. In this light, the checklist should be viewed as a tool that fiduciaries may consider using in helping them fulfill their duties and documenting that they have done so. [Checklist extracted from the White Paper by Reish, Ashton and Faucher referenced in the response to Question 3]

- **Strength and Stability**. Review publicly available information about the insurance company, including

  - financial reports (generally available on the insurer's website), paying special attention to the company's capital surplus and reserves;

  - the company's RBC and RBC ratio (which should be available upon request);

  - the actuarial opinion of the company's appointed actuary (which should also be available upon request); and

  - the company's Insurance Financial Strength ratings from the major rating agencies (generally available on the insurer's website or upon request).

  Comments:

  The company's reserves measure whether the company has sufficient assets to meet its obligations. Surplus is the amount of assets in excess of reserves and other liabilities, and is available to cover unanticipated risks. The higher the surplus in proportion to the annuities on the books, the stronger the company's claims paying ability.

As discussed earlier, RBC is an insurance company's risk based capital, which is a measure of the company's capital adequacy. The RBC ratio measures the company's capital on a scale that factors in the riskiness of its assets and liabilities. An RBC ratio of less than 100% leads to required action by the company and/or the regulators, ranging from the company filing a plan to correct its financial problems to mandatory takeover of the company if the ratio is less than 35%. Ratios of 300% to 400% or higher generally suggest that the company is well-capitalized and may be highly regarded.

The actuarial opinion is filed by the company with state regulators and confirms whether the company has adequate funds available to pay for anticipated cash outflows over the projected life of outstanding annuities. The opinion should certify that the company's reserves are adequate to pay the anticipated cash flows and expenses under in-force annuities. Fiduciaries should verify that the opinion contains such a confirmation.[10]

- **Ratings**. The following information regarding the insurer's Insurance Financial Strength ratings should be reviewed (all of which should be available on the insurer's website or upon request to the company):

  - the ratings over a period of years to determine whether they have been stable over time or have fluctuated during up and down economic cycles. Fluctuation may suggest financial instability. In addition, ratings on a comparative basis with other companies should be reviewed.

  - the ratings given by the major ratings agencies should be reviewed to determine the consistency (or lack of consistency) among the agencies.

  - to the extent possible, the report accompanying the ratings (which should be available on the company's website or upon request to the company) should be reviewed to determine whether there are adverse comments about the company that suggest vulnerability to future economic events.

  Comment: As noted earlier, we understand that the highest ratings are given to companies with RBC ratios above 300% to 400%.

  Fiduciaries should keep in mind that the major agencies use various letter grades to describe financially secure companies versus those that are vulnerable to adverse business conditions and, subject to the foregoing list of items, should presumably seek out companies with higher ratings. For example, Best's ratings of A++ and A+ are given to companies considered "superior" while those with a B or below rating are "vulnerable"; Fitch ratings of AAA and AA designate companies with little or no expectation of ceased or interrupted

[10] The actuarial opinion is accompanied by a memorandum that contains a detailed analysis and calculations that support the opinion. Because this memorandum contains confidential and proprietary information, it is not publicly available.

payments, while companies with lower ratings have some or considerable risk of ceased or interrupted payments; Moody's identifies "high grade" companies with an Aaa or Aa rating, while those with an A or lower rating have some or considerable susceptibility to impairment; and Standard & Poor's uses AAA and AA for companies with extremely or very strong financial security characteristics, whereas those ranked A or lower have some or considerable likelihood of being affected by adverse business conditions.

- **Track Record**. Seek an insurance company with a well-known reputation in the annuity field. Much of the information to be reviewed should be available through an internet search and could include:

  - how long the company has been in business;

  - whether the company has a history of processing annuity payments and has a large volume of such business, including the dollar amounts paid out historically and annually, the number of annuities issued and the number of annuitants receiving benefits (all of which should be available from the insurance company upon request);

  - information regarding the insurer's reputation and whether there has been material adverse information regarding the company in the news (which may be found through an internet search);

  - the company's regulatory history and any material litigation (which should be available upon request to the insurance company).

- **Costs.** Consider the cost of the annuity, including:

  - whether the company imposes sales charges, commission, surrender fees and other expenses that can reduce financial benefits to the participants. This information should be available in the description of the annuity product itself or upon request to the insurance company.

- **Transparency**. Assess whether the information to be reviewed is clear and readily available. If not, this may suggest that there is adverse information that the insurer is reluctant to disclose.

- **State Guarantees**. Consider the availability of state guarantee insurance in the states where the plan sponsor is located (and where most plan participants reside) and the extent of guarantee coverage for annuity contracts. This information should be available from the state insurance departments.

5. *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?*

In our view, employers should be under no obligation to consider an employee's assets outside the employer-sponsored plan. The issues are sufficiently complicated with respect to in-plan options that, in our view, employers should not be required or necessarily encouraged to consider out-of-plan options. Nevertheless, employers should be free to do so if they so choose.

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

As noted earlier, participants should be provided sufficient information for them to understand the cost of the income replacement option in relation to the benefit provided. We submit that a model similar to that imposed under the 404(a)(5) participant disclosure regime would be appropriate. That is, the participant should be informed of the methodology used in determining the cost and be provided with an illustration showing the impact of the cost in relation to a $1,000 investment.

For example, for a traditional annuity, the illustration could show the monthly income that would be purchased with a $1,000 investment based on specified interest rate assumptions. (Potentially, insurers may wish to provide illustrations showing the impact of differing interest rates, though we do not suggest that this be mandated.) For a GMWB option, the illustration could show that for a given premium payment (say, 75 basis points), the participant will achieve a specified guaranteed monthly income based on specified return assumptions.

The challenge of all of these disclosures will be to keep them simple enough to make them useful and not confuse unsophisticated participants. In this regard, it might be useful for the Department to encourage industry groups to submit (as they have in other contexts) proposed forms of disclosure that might prove useful or instructive rather than mandating a form of disclosure.

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

Please see our responses to previous questions.

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

There are several other barriers that interplay with the fiduciary concerns. The first is the portability issue discussed above. The second is how the qualified joint and survivor annuity (QJSA) requirements of the Internal Revenue Code interplay with certain of the options.

Clearly, the QJSA rules apply to traditional annuities, though how to apply them in the context of an in-plan periodic purchase of annuity options is somewhat problematic.

The other product principally affected by the uncertainty about application of the QJSA rules is the GMWB feature. The Internal Revenue Service has issued private letter rulings that address the issue, but has not issued guidance of broader applicability at this time. It is unclear whether a GMWB feature is an annuity in any case. Indeed, given how they function, they are arguably more like casually insurance products than annuities, in that the guarantee of payment only occurs if the participant's own funds are depleted and the insurance company begins to pay only if the triggering event – depletion of the participant's funds – occurs, not unlike in the case of a casualty policy under which the payment of benefits occurs only if the triggering event (an accident, fire, etc) occurs.

Regardless of the legal analysis that is applied, it is also difficult to see how to apply the QJSA rules in the GMWB context. Does the requirement for joint and survivor payments or a spousal consent waiving the requirement become operative when the participant elects to purchase the feature? If so, how does that operate? What about at retirement? And since the participant controls the withdrawal of his or her funds until they are depleted, how would the QJSA requirement be enforced? We do not mean to suggest that we have the answers. We only point out that these are issues that must be considered and on which guidance is required.