Written Testimony of
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# 2018 ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFIT PLANS
# LIFETIME INCOME SOLUTIONS AS A QUALIFIED DEFAULT INVESTMENT ALTERNATIVE (QDIA) – FOCUS ON DECUMULATION AND ROLLOVERS

June 19, 2018
9:00 am C5521 Room 4, U.S. Department of Labor

Thank you for inviting me to testify as you provide advice to the DOL for their guidance on how certain annuities could be a QDIA.

7 Key Findings:

1. Annuities are the most effective mechanism for converting accumulated wealth into post-retirement consumption. Most households have inadequate retirement savings, and annuitization will enhance their retirement security.

2. Households approaching retirement hold most of their retirement wealth not in 401(k)s, but in IRAs. Policymakers should encourage retention of money in 401(k)s, extend fiduciary protections to IRAs, and encourage annuitization of IRA wealth.

3. When attempting to manage investment and longevity risk, households are at risk of financial predation by salespersons pushing deferred annuities with opaque, high fees and expenses. Policymakers should discourage the use of these inappropriate products in 401(k)s and IRAs.

4. Although policymakers could encourage voluntary annuitization through financial education and the adoption of annuity marketplaces, I am skeptical that such initiatives will have much effect.

5. Regulations discourage plan sponsors from offering income annuities because safe harbor rules require liquidity and income annuities are illiquid.

6. Regulations should be amended to permit the use of income annuities as a QDIA but contain stringent safeguards to ensure that participants get the best value, get the appropriate products, and remain informed.

7. U.K. experience suggests that many, perhaps most, will opt out. Policymakers should consider mandating annuitization of part of plan balances, a reform that would also greatly reduce adverse selection.

The 2018 Council's objective is to focus recommendations on promoting lifetime income within DC plans through providing further guidance on an annuity selection safe harbor and modifying the Qualified Default Investment Rule to focus on asset accumulation and decumulation issues within the context of lifetime needs and solutions. I wholeheartedly support this initiative.

Annuities are the most effective means of converting accumulated wealth into post-retirement consumption. The reason is that households that attempt the alternative of undertaking a drawdown of unannuitized wealth must restrict consumption to avoid outliving their wealth. Theoretical calculations show that the benefits of annuitization are substantial relative to even an optimal drawdown.[1] But undertaking an optimal drawdown requires the household to undertake highly complex financial calculations. Most households likely follow sub-optimal rules of thumb, and the benefits of annuitization are even greater relative to such rules.[2] Empirical studies show that rather than drawing down wealth, many households continue to accumulate wealth into retirement. Although this behavior may be driven partly by rational concerns about out-of-pocket health and long-term care costs, it may also be indicative of the fear of mismanaging drawdown referred to in Professor Ghilarducci's testimony.[3]

The inefficient use of accumulated wealth would not be a matter for public policy concern if most households were well-prepared for retirement. Households could manage their assets inefficiently yet still enjoy comfortable retirements. But the United States faces a retirement savings crisis.[4] The majority of working age households will not be able to maintain their standard of living in retirement. They cannot afford the luxury of not annuitizing their retirement wealth.

The council is focusing on promoting annuitization within employer-sponsored plans. Most DC wealth is held, not in employer-sponsored plans, but in IRAs.[5] Measures to promote annuitization will have only limited effect unless participants are encouraged to retain their funds within the 401(k) system or those measures are expanded to include IRAs. IRA participants trying to manage investment and longevity risk are vulnerable to financial predation because the solutions offered by advisors, bound only by a suitability standard, are often characterized by high, opaque fees and manage longevity risk inefficiently.

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[1] Brown and Poterba (2000).
[2] Sun and Webb (2013).
[3] DeNardi, French, and Jones (2009).
[4] Munnell, Rutledge, and Webb (2014).
[5] Munnell and Webb (2015).

To elaborate on this point, I will discuss what I believe to be a critical distinction between income and deferred annuities.

*Income Annuities*

Income annuities are what most laypeople think of as annuities, but only represent a small part of the annuity market.[6] Economic studies demonstrating the benefit of annuitization model the benefits of this class of annuity product. With an income annuity, the household irrevocably hands over its capital in return for a lifetime income. The income may be fixed in nominal terms, increase at a predetermined rate, like being linked to the Consumer Price Index, or, in the case of a variable income annuity, indexed to the return on a portfolio of financial assets.

In the case of a deferred income annuity, the income may start at some future age, not exceeding 85. One can think of a deferred income annuity as longevity insurance with a large deductible, the deductible being pre-age 85 consumption. Calculations show that this product may offer even greater benefits than an income annuity with benefits starting immediately.[7] The reason is that it becomes progressively more expensive to self-insure consumption at older ages. The probability of living to age 100 may be only 1 percent, so 99 percent of the time, money set aside to fund that consumption is wasted. In contrast, households can be fairly sure of surviving (say) from age 65 to age 66 and even small expense loads can tip the balance in favor of self-insuring consumption at that age.

*Deferred annuities*

The second and much more common type of annuity is the deferred annuity. This is an investment product with a surrender value and a series of guarantees, one of the most important of which is a guaranteed lifetime withdrawal benefit (GLWB). In its simplest form, the GLWB gives the policyholder the right to withdraw a certain percentage of the sum originally invested for as long as the policyholder lives. Other riders can be more complex and opaque. It is my assessment that the increasing complexity has been driven more by a desire on the part of insurers to differentiate their products and gain pricing power than by any genuine consumer financial need.

With some exceptions, deferred annuities are characterized by high commissions and high, opaque charges.[8] These charges are met by liquidating mutual fund investments held within the policy, and can result in rapid depletion of the account balance. Deferred annuities provide considerably less lifetime income per dollar invested than immediate annuities, due to the charges and the fact that

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[6] LIMRA https://www.limra.com/Posts/PR/Data_Bank.aspx
[7] Gong and Webb (2010).
[8] Milevsky and Posner (2001) show that deferred annuity charges for guaranteed minimum death benefits are of an order of magnitude greater than the value of the embedded option.

they have a surrender value. They are often sold based on their supposed tax advantages, which have no value within a tax deferred retirement account. The high commissions likely contribute to their dominance in the annuity market. The deferred annuity market has also been characterized by allegations of deceptive sales practices.[9] I see no place for deferred annuities within 401(k) plans or IRA accounts and certainly not within a QDIA.

I will now discuss practical and regulatory issues involved in including income annuities as a QDIA.

*Practical Issues*

The practical problems flow from the fact that the purchase of an immediate annuity is an irreversible decision. Insurance companies suffer adverse selection by purchasers and would suffer even greater adverse selection if they were to allow purchasers an unlimited right to surrender their annuities. The sick would surrender, while the healthy retained their policies.

Plan participants investing in QDIAs are likely to be financially unsophisticated, and even with the best outreach may not understand the financial implications. This would not matter too much if one type of immediate annuity were clearly an appropriate choice for all participants. But it is not clear what would constitute an appropriate choice. Some participants may be better off with an immediate annuity with payments fixed in nominal terms; others with payments fixed in real terms, or with a variable immediate annuity, a product providing a lifetime income, the amount of which varies with the performance of an underlying fund. By law, men and women face the same annuity rates within a 401(k) plan, whereas IRA rates vary by gender. Is it appropriate to default men into a 401(k) annuity if better rates can be obtained by rolling over their money into an IRA? How much of the participant's 401(k) plan balance should be annuitized? All of it, enough to lift the participant out of near poverty, or something in between? Although the very sick should not annuitize, those in poor health might still benefit because they might survive longer than expected. But where should the line be drawn?[10]

I believe these problems are soluble. One solution might be to default households into an income annuity for a trial period of (say) two years.[11] But we should have stringent safeguards. Plan sponsors should be required to obtain the most competitive price, consistent with financial stability, perhaps through the creation of an online annuity marketplace similar to that offered by Income

[9] A Google search of the key words "deferred annuity" and "class action lawsuit" yielder over 7,000 results.
[10] Gong and Webb (2008).
[11] Iwry and Turner (2009).

Solutions.[12] Participants should be kept fully informed and perhaps be required to acknowledge receipt of educational materials.[13]

*Regulatory issues*

The regulations recognize that participants should be able to undo defaults that they may later decide do not meet their needs. Section 404 (c) (5) of the QDIA regulations provides fiduciary relief for plan sponsor defaults, provided the participant can transfer such assets "in whole or in part" to any other investment alternative available under the plan. As the purchase of an income annuity is irreversible, this section effectively denies fiduciary relief to the use of an income annuity default.

But in an information letter dated 22 December 2016, the Department of Labor indicated that a plan sponsor may be able to conclude, without regard to the fiduciary relief available under section 404 (c) (5), that an investment product is a prudent default. The letter then discusses the circumstances in which a product might be so deemed, referencing the need for education of affected participants as well as other factors. The information letter was drafted in response to a request for guidance as to whether a partially liquid product - it could only be liquefied over a period of 84 months - met the conditions for a QDIA. More stringent safeguards might be required for a totally illiquid investment. I hypothesize that plan sponsors will be deterred from offering income annuities as a QDIA due to uncertainty around the required standard of conduct.

Policymakers should consider extending fiduciary relief to income annuities, notwithstanding their illiquidity, but subject to stringent safeguards. Regulations might stipulate that plan sponsors choose the best value product on an income annuity marketplace, that participants could only be defaulted into the product only after acknowledging receipt of educational materials, and that participants have a two-year cooling-off period.

I will now discuss the likely effect of a QDIA income annuity default on annuitization rates and the alternative of an annuity mandate.

Although I agree with Professor Ghilarducci's testimony that households that annuitize express higher levels of post-retirement financial satisfaction, I remain skeptical that even well-crafted defaults will significantly increase annuitization rates. Defaults work well when households knowthey are appropriate, but suffer

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[12] Income Solutions operates an on-line annuity marketplace offering low-cost prices and the ability to compare prices and financial ratings. www.incomesolutions.com

[13] The experience of the U.K shows that households do not compare prices when purchasing annuities. The U.K. DC system mandated annuitization, with the default being the annuity offered by the DC financial institution, often a poor value product. Although participants had an open market option, few availed themselves of it. A potential concern with a marketplace is that participants may lack the mathematical and reading skills to interpret even simple tables. Hence, the default should be the most competitive product.

from inertia and present bias. They work less well when households strongly prefer some other choice. The experience of the U.K, which used to mandate annuitization of DC account balances but eliminated the mandate in a series of reforms, indicates that households are highly averse to annuitizing DC account balances.

Given likely high levels of annuity aversion, by far the most effective way of reducing adverse selection is to mandate annuitization. It is inappropriate to annuitize very small account balances, very large account balances, or to leave households without any liquidity. So the mandate could perhaps follow past U.K practice by capping annuity income at an amount sufficient to raise the household's income, inclusive of Social Security benefits, to some multiple of the Federal Poverty Level. The mandate might also require annuitization of only a portion of accumulated wealth, even if that resulted in the household falling short of its income target.

Prior to adopting a default, policymakers should consider whether the immediate annuity product design could be improved. High annuity prices reflect adverse selection, but they also reflect an inefficient allocation of longevity risk. With most current annuity products, insurers bear both longevity and investment risk. Insurers hedge longevity risk by purchasing reinsurance, but some scholars have argued that it would lead to more efficient risk sharing and lower annuity prices if this risk were transferred to the capital markets using longevity bonds.[14] Other scholars have drawn a distinction between individual mortality risk, the risk that you live longer than expected and aggregate mortality risk, the risk that the average mortality of a class of annuitants is lower than expected, perhaps because of unanticipated advances in medical science. Insurers can reduce the former risk to negligible levels by increasing the size of their annuity pool, but they cannot similarly reduce the latter risk. Insurers must hold reserves to safeguard against this latter risk and earn a return on those reserves, increasing premiums.

A substantial reduction in mortality might result in insurance company insolvency. Although policyholders are protected by state level guaranty funds, compensation is limited and there is no explicit government backstop. The concern is that if annuitization ever became widespread, an unexpected decline in mortality could lead to insurance company defaults and loss of benefits.

I consider that a better solution would be for policyholders, not insurers, to bear aggregate mortality risk, so that policy benefits would be adjusted if average mortality proved to be higher or lower than expected. The TIAA traditional annuity operates on similar principles. For plausible mortality shocks, changes in income would be relatively small, and policyholders would continue to be protected against what is, from their perspective, the far greater risk of outliving their peers.

[14] Blake, Boardman, and Cairns. 2010.

Similar considerations apply to investment risk. The majority of immediate annuities pay benefits that are fixed in nominal terms. Finance theory posits that households should gradually rebalance away from stocks in favor of bonds as they age.[15] For plausible risk preferences, retirees should continue to hold a substantial proportion of their wealth in stocks. Yet annuities are bond-like in that they offer a completely guaranteed return. For many, a variable income annuity in which payments vary with the performance of an underlying fund would be a more attractive option, yielding higher expected returns.

I endorse Professor Ghilarducci's statement that an even better approach would be to encourage annuitization by encouraging workers to postpone claiming Social Security, using their retirement savings to finance consumption between retirement and claiming.[16] A worker who delays claiming Social Security is, in effect, making an additional annuity purchase. The worker can be thought of as purchasing the increased benefits resulting from delay with the benefits foregone during the period of delay. The terms on which workers can purchase annuity income from the Social Security Administration are considerably more favorable than those on offer from insurance companies, reflecting not excessive generosity but low administrative costs and the absence of risk capital on which a return must be earned. To illustrate, a worker with a Full Retirement Age of 66 who delays from 66 to 67 earns an eight percent income return on his Social Security annuity purchase. In contrast, inflation indexed annuities currently offer income returns of under five percent at the same ages. Policymakers should consider a temporary annuity, bridging the gap between retirement and claiming, as a QDIA.

To conclude, regulators face conflicting goals. They want to prevent financial abuse, preserve individual choice, help households make good decisions – which, in this context, means choosing immediate annuities - and address failures in the individual market. These objectives sometimes conflict. For example, a mandate would improve the functioning of the annuity market and probably lead to better outcomes for most households, but at the cost of restricting choice. An attempt should be made to increase annuitization rates through QDIAs. I hope it works. But if it does not, we should not shy away from a mandate.

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[15] The rationale is not that risk preferences change with age or that stocks are less risky in the long-run, but that younger households a large low-risk asset – the expected present value of their lifetime earnings – and can afford to take risks with the small part of their wealth held in financial assets.
[16] Sun and Webb (2011)

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