LIFETIME INCOME SOLUTIONS AS A QUALIFIED DEFAULT INVESTMENT ALTERNATIVE (QDIA) FOCUS ON DECUMULATION AND ROLLOVERS

Written Testimony of

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for the

ERISA Advisory Council

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Members of the ERISA Advisory Council:

I want to thank the ERISA Advisory Council for this opportunity to help the Council and the U.S. Department of Labor promote lifetime income solutions in defined contribution plans.

I am the Alfred P. Murrah Professor of Law at the University of Oklahoma College of Law where I teach courses on tax and pension law. I am also a Fellow in the American College of Employee Benefits Counsel, a Fellow in the Employee Benefits Research Institute, and a Fellow in the TIAA Institute (although I am here in my individual capacity).

After a brief Executive Summary, Part I of my statement provides some background on the sources of lifetime retirement income in the United States, and Part II explains the regulation of annuities in defined contribution plans. Part III then offers some recommendations related to your project.

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EXECUTIVE SUMMARY

Longevity risk—the risk of outliving one's retirement savings—is probably the greatest risk facing current and future retirees. (See Part I.A.) Elderly Americans usually get their retirement income from a combination of Social Security, annuities, and pensions. (See Part I.B.)

Over the past few decades, there has been a major shift from traditional defined benefit plans to defined contribution plans. Unlike defined benefit plans, defined contribution plans usually make lump-sum or periodic distributions. To be sure, defined contribution plans can offer annuities; however, relatively few plans do, and, in any event, relatively few participants elect those annuity options. For example, in 2017 annuity payments were available to just 12 percent of workers in savings and thrift plans, to just 9 percent of workers in deferred profit-sharing plans, and to just 29 percent of workers in money purchase pension plans. (See Part I.B.3.)

In the coming years, annuities will play an ever more important role in defined contribution plans. First, more defined contribution plans may offer deferred income annuities among their investment options. Second, more defined contribution plans may offer participants the option to annuitize their account balances at retirement or job separation. Third, some defined contribution plans may want to help their retirees take a lump sum distribution (or roll over their account balance into an IRA) and subsequently purchase an annuity. (See Part II.)

When a defined contribution plan offers an annuity, the selection of an annuity provider is a fiduciary function. Under the qualified default investment alternatives (QDIA) regulations, defined contribution plans can offer annuities. In particular, target date funds that serve as QDIAs may include annuities as part of their investment portfolios. Defined contribution plans can also offer deferred income annuities known as "qualifying longevity annuity contracts" (QLACs). (See Part II.B.)

The U.S. Department of Labor should develop a workable safe harbor for plan sponsors to offer annuities and other lifetime income products. Basically, the current QDIA regulations contemplated a world in which plan sponsors let participants change what they are invested in at least once every three months (e.g., from one stock fund to another). Unfortunately, that QDIA condition just will not work with lifetime annuities: annuity providers simply cannot refund premiums, for example, when policyholders discover serious health problems. Nor should annuity providers have to establish that their annuity investment alternatives satisfy a "facts and circumstances" test to otherwise qualify as appropriate default investment alternatives. Instead, the U.S. Department of Labor should craft a specific safe harbor for annuities that relaxes that periodic transfer condition. (See Part III.A.)

Also, better guidance on the process of selecting qualifying longevity annuity contracts (QLACs) and other deferred income annuities would increase their utilization. (See Part III.A.)

The U.S. Department of Labor should also make it easier for plan sponsors to provide financial advice generally, and guidance about lifetime income options specifically. (See Part III.B.) The U.S. Department of Labor should also broaden the range of permissible lifetime income products. (See Part III.C.)

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I. PRINCIPAL SOURCES OF LIFETIME INCOME

A. Longevity Risk

Longevity risk—the risk of outliving one's retirement savings—is probably the greatest risk facing current and future retirees. At present, for example, a 65-year-old man has a 50 percent chance of living to age 83 and a 20 percent chance of living to age 91, and a 65-year-old woman has a 50 percent chance of living to age 86 and a 20 percent chance of living to age 94.[1] The joint life expectancy of a 65-year-old couple is even more remarkable: there is a 50 percent chance that at least one 65-year-old spouse will live to age 90 and a 30 percent chance that at least one will live to 94.[2] In short, many individuals and couples will need to plan for the possibility of retirements that can last for 30 years or more. Consequently, the need for lifetime retirement-income products to protect against longevity risk has never been greater.

B. Current Sources of Lifetime Income

Elderly Americans usually get their retirement income from a combination of Social Security, annuities, and pensions.

1. Social Security

The United States established its Social Security program in 1935.[3] Elderly Americans can generally count on Social Security benefits to cover at least a portion of their retirement income needs. For example, in April of 2018, Social Security paid retirement benefits to more than 42.9 million retired workers, and the average monthly benefit paid to a retired worker was $1411.07.[4] Another 2.2 million elderly Americans received means-tested Supplemental Security Income (SSI) benefits from the federal government, and their average monthly benefit was $446.42.[5]

2. Annuities

Annuities are another common way to provide lifetime income.[6] For example, for a 65-year-old man who purchased a $100,000 immediate fixed (lifetime) annuity without inflation protection on December 1, 2017, the annual payment would be about $6,264.[7] In addition to lifetime

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[1] Calculations from the Society of Actuaries, *Life Expectancy Calculator*, https://www.soa.org/Files/Xls/research-life-expect-calc.xls (last visited June 5, 2018) (based on the Social Security Administration's 2010 mortality tables for the general U.S. population; an individual's life expectancy is the average number of years until death).

[2] *Id.* Appendix 1(C) offers additional information on the demographics of life expectancy.

[3] Social Security Act, Public Law No. 74-271, 49 Statutes at Large 620.

[4] Social Security Administration, *Monthly Statistical Snapshot, April 2018* 2 tbl.2 (May 2018), https://www.ssa.gov/policy/docs/quickfacts/stat_snapshot/2018-04.pdf.

[5] *Id.* at 3 tbl.3.

[6] An annuity is a financial instrument (i.e., an insurance contract) that converts a lump sum of money into a stream of income payable over a period of years, typically for life. *See, e.g.*, U.S. Securities and Exchange Commission, *Annuities*, http://www.sec.gov/answers/annuity.htm (last updated Apr. 6, 2011). The person holding an annuity is called an annuitant. *See, e.g.*, Investopedia, *Annuitant*, http://www.investopedia.com/terms/a/annuitant.asp (last visited June 5, 2018).

[7] Immediate Annuities, *Annuity Shopper Buyer's Guide* 33, no. 1 (Jan. 2018): 17 tbl.5, https://www.immediateannuities.com/pdfs/as/annuity-shopper-2018-01.pdf ($6,264 per year = 12 × an average

annuities based on a single life, it is also possible to buy lifetime annuities that are based on the joint lives of a couple. For example, for a couple consisting of a 65-year-old man and a 60-year-old woman who purchased a $100,000 immediate, fixed (50-percent) joint and survivor annuity without inflation protection on December 1, 2017, the annual payment would be around $5,772.[8]

Inflation-adjusted annuities offer an even better way to hedge against living too long. With inflation-adjusted annuities, annual payments would start out lower than with level-payment fixed annuities but could end up higher. For example, if our hypothetical 65-year-old man instead chose an annuity stream with a 3-percent annual escalator, the initial annual payment would be just $3,804, but, eventually, the annual payments would exceed the $6,264 per year under the level-payment fixed lifetime annuity.[9]

Alternatively, retirees can protect against longevity risk by purchasing deferred income annuities.[10] The typical approach is to buy a deferred income annuity at age 65 that starts making annual payments only if the annuitant lives past age 80 or 85.[11]

Also, variable annuities allow the annuitant to select from a range of investment options, and the annuitant can do better if the underlying investments do well, or worse if those investments perform poorly.[12]

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payment of $522 per month). *See also* Investopedia, *Fixed Annuity*, http://www.investopedia.com/terms/f/fixedannuity.asp (last visited June 11, 2018).

[8] *Id.* at 25 tbl.11 ($5,772 per year = 12 × an average payment of $481 per month). Appendix 1(A) explains the mathematics of converting a lump sum into an annuity, and Appendix 1(B) compares retail annuities and actuarially fair annuities.

[9] *Id.* at 17 tbl.5 (showing average monthly payments to 65-year-old men with a 3-percent-cost-of-living adjustment of $375 per month in the first year of his retirement; $3,804 in the first year = 12 × an average payment of $375 per month).

[10] *See, e.g.*, Katherine G. Abraham & Benjamin H. Harris, *The Market for Longevity Annuities*, 3 JOURNAL OF RETIREMENT 12 (2016); Daniel Cassidy, *Making Retirement Income Last a Lifetime* 68(1) FINANCIAL ANALYSTS JOURNAL 74 (2012).

[11] With a relatively small upfront investment, a retiree can secure an income stream that starts sometime in the future, and the retiree can then use the rest of her savings to cover the fixed number of years until the year that the deferred income annuity payments start. There is some risk of running out of money before the year that the deferred income annuity starts, but that is certainly a more manageable risk than trying to manage one's retirement savings over the indefinite future.

[12] *See, e.g.*, Investopedia, *Variable Annuity*, http://www.investopedia.com/terms/v/variableannuity.asp (last visited June 12, 2018); U.S. Securities and Exchange Commission, *Variable Annuities: What You Should Know* (Apr. 18, 2011), http://www.sec.gov/investor/pubs/varannty.htm.

While the market for annuities is well-developed in the United States, the penetration rate is fairly low; for example, annuities represented just 8 percent of retirement assets in 2016.[13] When given the choice, people rarely choose to buy annuities.[14]

3. Pension Plans

The United States has a "voluntary" private pension system, and employers can decide whether and how to provide pension benefits for their employees.[15] In March of 2017, just 66 percent of private-sector workers in the United States had access to pension plans, and only 50 percent participated.[16] Pension plans generally fall into two broad categories based on the nature of the benefits provided: defined benefit plans and defined contribution plans.

The default benefit for defined benefit plans is a retirement income stream in the form of a lifetime annuity.[17] For example, a plan might provide that a worker's annual retirement benefit (*B*) is equal to 2 percent times the number of years of service (*yos*) times final average compensation (*fac*) (B = 2 percent × *yos* × *fac*). Under that formula, a worker who retired after 30 years of service with final average compensation of $50,000 would receive a pension of $30,000 a year for life ($30,000 = 2 percent × 30 *yos* × $50,000 *fac*). While many defined benefit plans allow for lump sum distributions, most retirees receive lifetime annuities. For example, according to the U.S. Government Accountability Office, 67.8 percent of workers who left employment and retired with a defined benefit pension from 2000 through 2006 took the defined benefit plan annuity.[18]

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[13] At the end of 2016, there were $2.4 trillion in annuities out of a total of $29.1 trillion in household retirement assets, or approximately 8 percent (0.07828 = $2.4088 trillion/$29.0798 trillion). Board of Governors of the Federal Reserve System, *Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts: Fourth Quarter 2017* 94 tbl.L.117 (Mar. 8, 2018), https://www.federalreserve.gov/releases/z1/20180308/z1.pdf.

[14] *See, e.g.*, Shlomo Benartzi, Alessandro Previtero & Richard H. Thaler, *Annuitization Puzzles*, 25(4) JOURNAL OF ECONOMIC PERSPECTIVES 143 (Fall 2011), https://www.aeaweb.org/articles?id=10.1257/jep.25.4.143. *See also* Appendix 1(E) on the challenges to annuitization in the United States.

[15] *See, e.g.*, Jonathan Barry Forman & George A. (Sandy) Mackenzie, *The Cost of "Choice" in a Voluntary Pension System*, 2013 NEW YORK UNIVERSITY REVIEW OF EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION 6-1.

[16] U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in the United States—March 2017* 6 tbl.1 (New Release No. USDL-17-1013, July 21, 2017), http://www.bls.gov/news.release/pdf/ebs2.pdf.

[17] Defined benefit plans are generally required to provide "definitely determinable benefits … over a period of years, usually for life after retirement." 26 Code of Federal Regulations (C.F.R.) § 1.401-1(b)(1). For married participants, defined benefit plans (and some defined contribution plans) are required to provide a qualified joint-and-survivor annuity (QJSA) as the normal benefit payment, unless the spouse consents to another form of distribution. Employee Retirement Income Security Act of 1974 (ERISA) § 205, 29 U.S.C. § 1055; Internal Revenue Code (I.R.C.) § 401(a)(11). A QJSA is an immediate annuity for the life of the pension plan participant and a survivor annuity for the life of the participant's spouse.

[18] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-11-400, RETIREMENT INCOME: ENSURING INCOME THROUGHOUT RETIREMENT REQUIRES DIFFICULT CHOICES 26 (2011), http://www.gao.gov/new.items/d11400.pdf.

Over the past few decades, there has been a major shift from traditional defined benefit plans to defined contribution plans.[19] Under a typical defined contribution plan, the employer simply withholds a specified percentage of the worker's compensation, which it contributes to an individual investment account for the worker. For example, contributions might be set at 10 percent of annual compensation.[20] Under such a plan, a worker who earned $50,000 in a given year would have $5,000 contributed to an individual investment account for her ($5,000 = 10 percent × $50,000). Her benefit at retirement would be based on all such contributions plus investment earnings.

Unlike defined benefit plans, defined contribution plans usually make lump-sum or periodic distributions. To be sure, defined contribution plans can offer annuities; however, relatively few plans do, and, in any event, relatively few participants elect those annuity options.[21] For example, the following chart from the U.S. Bureau of Labor Statistics shows that in 2017 annuity payments were available to just 12 percent of workers in savings and thrift plans, to just 9 percent of workers in deferred profit-sharing plans, and to just 29 percent of workers in money purchase pension plans.[22]

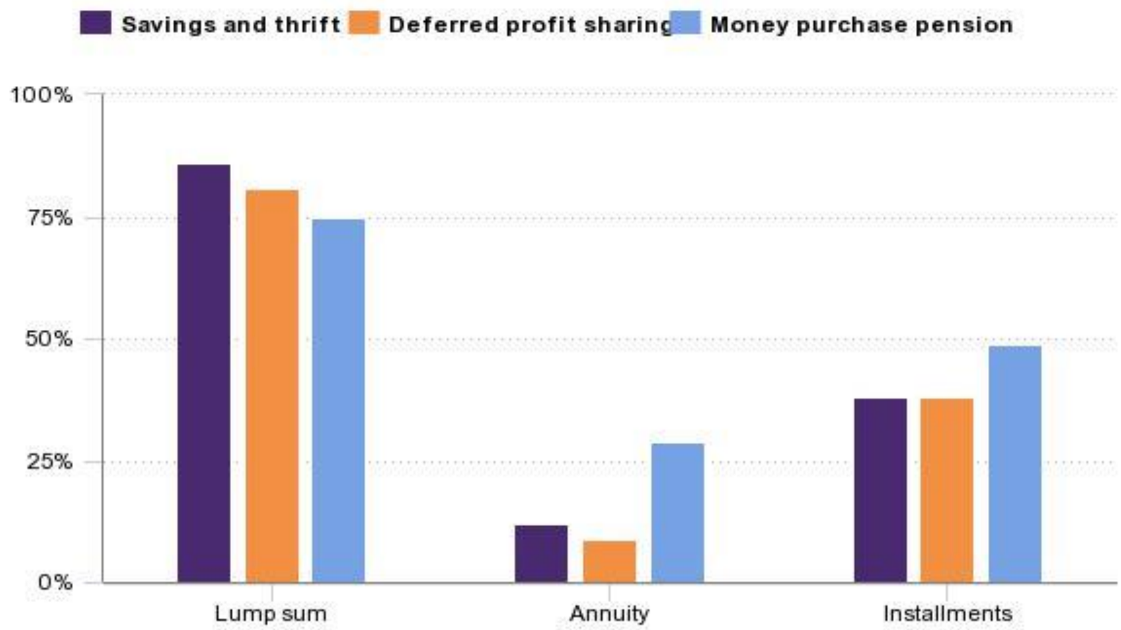
[19] *See, e.g.*, Staff of the Joint Committee on Taxation, *Present Law And Background Relating To Tax-Favored Retirement Saving And Certain Related Legislative Proposals* 54–57 (JCX-3-16, 2016), https://www.jct.gov/publications.html?func=download&id=4865&chk=4865&no_html=1at.

[20] Profit-sharing and stock bonus plans often include a feature that allows workers to choose between receiving cash currently or deferring taxation by placing the money in a retirement account according to I.R.C. § 401(k). Consequently, these plans are usually called "401(k) plans," and they are the most popular type of retirement plan in the United States. *See, e.g.*, U.S. Department of Labor, Bureau of Labor Statistics., *BLS examines popular 401(k) retirement plans*, 2(6) PROGRAM PERSPECTIVES 1 (Nov. 2010), http://www.bls.gov/opub/perspectives/program_perspectives_vol2_issue6.pdf.

[21] *See, e.g.*, U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Health and Retirement Plan Provisions in Private Industry in the United States, 2017* tbl.20 (Bulletin No. 2788, May 2018), https://www.bls.gov/ncs/ebs/detailedprovisions/2017/ownership/private/health-retirement-private-benefits-2017.pdf (showing that just 12 percent of private industry workers participating in savings and thrift plans had an annuity distribution option available to them); Defined Contribution Institutional Investment Association, *Design Matters: Plan Distribution Options* 4−5 (May 2018), https://c.ymcdn.com/sites/dciia.org/resource/collection/F3BE0E33-FB72-44A0-86A1-78B6CA99454D/Design_Matters_Distribution_25apr18.pdf (summarizing recent research on common distribution practices today); Jonathan Barry Forman, *Removing the Legal Impediments to Offering Lifetime Annuities in Pension Plans*, 23(1) *CONNECTICUT INSURANCE LAW JOURNAL* 43−45 (Fall 2016), http://insurancejournal.org/wp-content/uploads/2017/03/2-Forman-1.pdf (citing additional sources on the low level of annuitization options in defined contribution plans).

[22] U.S. Department of Labor, Bureau of Labor Statistics, *Lump sums are most common payment option for participants in defined contribution retirement plans* (The Economics Daily, June 4, 2018), https://www.bls.gov/opub/ted/2018/lump-sums-are-most-common-payment-option-for-participants-in-defined-contribution-retirement-plans.htm.

Percent of participants in defined contribution retirement plans by methods of payment available, 2017



Click legend items to change data display. Hover over chart to view data.
Source: U.S. Bureau of Labor Statistics.

According to a Callan Institute survey of 152 defined contribution plan sponsors in 2017, some of the reasons that plans sponsors give for not offering annuities include: a belief that it is unnecessary or not a priority, concerns about fiduciary responsibility, a lack of participant need or demand, and the high cost of annuities.[23]

To be sure, many employers are interested in offering retirement income solutions for their employees, and there are many examples of best practices.[24] In particular, it is worth noting that 84 percent of employer-sponsored 403(b) plans (for governmental and tax-exempt employers) do offer annuities as an investment option.[25] In particular, it is worth noting that TIAA reports that

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[23] Callan Institute, *2018 Defined Contribution Trends* 41–42 (2018), https://www.callan.com/wp-content/uploads/2018/01/Callan-2018-DC-Survey.pdf..

[24] *See, e.g.*, Defined Contribution Institutional Investment Association, *Retirement Income Solutions: A Guide for Plan Sponsors* (Dec. 2015), https://cdn.ymaws.com/dciia.org/resource/collection/FE176303-854B-47F3-B142-8BCD50021DEB/12-2015-_White_Paper_%E2%80%93_Retirement_Income_Solutions.pdf.

[25] *Enhancing Retirement Security: Examining Proposals to Simplify and Modernize Retirement Plan Administration, Hearing before the Subcommittee on Health, Education, Labor, and Pensions of the House Education and Workforce Committee*, 115th Cong., 2nd Sess. (statement of Tim Walsh, Senior Managing Director, TIAA) (May 16, 2018), https://edworkforce.house.gov/uploadedfiles/testimony_t._walsh__5.16.18.pdf. For more on I.R.C. § 403(b) plans, *see, e.g.*, Staff of the Joint Committee on Taxation, *Present Law And Background Relating To Tax-Favored Retirement Saving And Certain Related Legislative Proposals*, *supra* note 19, at 18–19.

around 75 percent of its beneficiaries actually receive annuity payments.[26] Also, some public sector plans allow their retirees to convert the balances in their defined contribution plans to annuities.[27] Pertinent here, the federal government's Thrift Savings Plan offers a variety of annuities to its participants.[28]

Individuals can also use individual retirement accounts (IRAs) to provide lifetime income. For example, an individual might roll over a lump sum pension distribution into an IRA and then have the IRA purchase an annuity.[29]

4. Other Sources of Lifetime Income

In addition to voluntary saving through 401(k) elections and IRAs, individuals can also save money outside of the retirement system. One of the simplest and most common strategies for using such savings to create retirement income is to invest all of the retirement savings in a diversified portfolio and then use a phased withdrawal strategy to stretch payments out over 20 or 30 years.[30] This phased withdrawal strategy can be used with free-standing savings or with retirement savings in defined contribution plans, IRAs, and those defined benefit plans that permit periodic withdrawals. People can also use reverse mortgages on their houses to help provide them with retirement income.[31]

II. The Regulation of Annuities in Defined Contribution Plans

In the coming years, annuities will play an ever more important role in defined contribution plans. First, more defined contribution plans may offer deferred income annuities among their investment options. Second, more defined contribution plans may offer participants the option to annuitize their account balances at retirement or job separation. Third, some defined contribution plans may want to help their retirees take a lump sum distribution (or roll over their account balance into an IRA) and subsequently purchase an annuity.

[26] Josh B. McGee, *Defined-Contribution Pensions Are Cost Effective* 13 (Center for State and Local Government Leadership at the Manhattan Institute, Aug. 2015), https://www.manhattan-institute.org/download/6361/article.pdf.

[27] *See, e.g.*, Diane Oakley & Jennifer Erin Brown, *Preserving Retirement Income Security for Public Sector Employees* 14 (National Institute on Retirement Security, July 2016), http://www.nirsonline.org/storage/nirs/documents/Portability%20Report/preserving_security_public_sector_web.pdf (noting that the Colorado Public Employees' Retirement Association allows retirees to convert their defined contribution account balances into annuities "at the PERA assumed rate of return, which is less costly than purchasing an annuity from an insurance company").

[28] Thrift Savings Plan, *Life Annuities: Your TSP Annuity Options*, https://www.tsp.gov/PlanParticipation/LoansAndWithdrawals/annuities/options.html (last viewed June 11, 2018).

[29] *See, e.g.*, Hersh Stern, *Can I Buy An Annuity With My IRA or 401k?* (May 4, 2018), https://www.immediateannuities.com/roll-over-ira-or-401k/.

[30] *See, e.g.*, Forman, *Removing the Legal Impediments to Offering Lifetime Annuities in Pension Plans*, *supra* note 21, at 55−59.

[31] *See, e.g.*, U.S. Department of Housing & Urban Development, *Frequently Asked Questions About HUD's Reverse Mortgages*, http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm/rmtopten (last visited June 11, 2018).

[31] ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A); I.R.C. § 401(a).

A. Regulatory Overview

Since it was enacted more than 40 years ago, the Employee Retirement Income Security Act (ERISA) has been amended numerous times, and a whole regulatory system has grown up to enforce its provisions. The key agencies charged with the administration of ERISA are the U.S. Department of Labor's Employee Benefits Security Administration (EBSA), the Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corporation (PBGC).

Pension plans must be operated for the exclusive benefit of employees (and beneficiaries).[32] To protect the interests of plan participants, ERISA requires significant reporting and disclosure in the administration and operation of employee benefit plans.[33]

ERISA also imposes extensive fiduciary responsibilities on plan sponsors and the administrators of employee benefit plans.[34] In general, a fiduciary includes any person who: (1) exercises any authority or control respecting management or disposition of the plan's assets; (2) renders investment advice for a fee or other compensation with respect to any plan money or property, or has the authority or responsibility to do so; or (3) has any discretionary authority or responsibility in the administration of the plan.[35] Fiduciary responsibilities include:

(1) acting solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them;

(2) carrying out their duties prudently;

(3) following the plan documents (unless inconsistent with ERISA);

(4) diversifying plan investments; and

(5) paying only reasonable plan expenses.[36]

In addition to the fiduciary responsibility rules, the prohibited transaction rules prevent parties in interest from engaging in certain transactions with the plan.[37]

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[32] ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A); I.R.C. § 401(a).

[33] ERISA §§ 101(a) et seq., 29 U.S.C. § 1021 et seq. *See also* U.S. Department of Labor, Employee Benefits Security Administration, *Reporting and Disclosure Guide for Employee Benefit Plans* (Sept. 2017), https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/reporting-and-disclosure-guide-for-employee-benefit-plans.pdf.

[34] ERISA § 404, 29 U.S.C. § 1104; I.R.C. § 401(a).

[35] ERISA § 3(21), 29 U.S.C. § 1002(21).

[36] U.S. Department of Labor, Employee Benefits Security Administration, *Meeting Your Fiduciary Responsibilities* 2 (Sept. 2017), https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/meeting-your-fiduciary-responsibilities.pdf.

[37] ERISA § 406, 29 U.S.C. § 1106; I.R.C. § 4975. For example, an employer usually cannot sell, exchange, or lease any property to the plan.

B. Rules Governing the Purchase and Monitoring of Annuities

Defined contribution plans can include annuities among their investment alternatives.[38] When a defined contribution plan offers an annuity, the selection of an annuity provider is, of course, a fiduciary function.[39] Under the current annuity selection safe harbor, a defined contribution plan fiduciary satisfies its fiduciary responsibility if the fiduciary:

(1) engages in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;

(2) appropriately considers information sufficient 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; and

(5) if necessary, consults with an appropriate expert or experts for purposes of compliance with these provisions.[40]

A defined contribution plan sponsor also has a duty to monitor the appropriateness of the annuity providers that it selects, but that duty ends when the plan transfers the plan's liability with respect to the participant's benefits to that annuity provider.[41]

While a defined contribution plan sponsor can select the investments for its plan, ERISA Section 404(c) generally allows plans to permit individual participants to direct their own investments (a/k/a, "self-directed" or "participant-directed" accounts).[42] To be eligible for this safe harbor, the plan must provide the participant with the opportunity "to exercise control over assets in his

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[38] *See, e.g.*, Raimond Maurer, Olivia Mitchell, Vanya Horneff & Ralph Rogalla, *Variable Annuities, Lifetime Income Guarantees, and Investment Downside Protection* 1 (TIAA Institute, Mar. 2016), https://www.tiaainstitute.org/sites/default/files/presentations/2017-02/ti_variable_annuities_lifetime_income_guarantees.pdf; TIAA-CREF Financial Services, *The Case for Guaranteed Annuities in Defined Contribution Plans* (Oct. 2010), https://www.tiaa.org/public/pdf/case_guaranteed_annuities.pdf.

[39] 29 C.F.R. § 2550.404a-4.

[40] *Id. See also* Field Assistance Bulletin 2015-2 (U.S. Department of Labor, Employee Benefits Security Administration, July 13, 2015), http://www.dol.gov/ebsa/pdf/fab2015-2.pdf (clarifying the meaning of "the time of selection").

[41] Field Assistance Bulletin 2015-2, *supra* note 40.

[42] ERISA § 404(c), 29 U.S.C. §1104(c) (providing plans with a "safe harbor" from liability for losses that a participant suffers in their 401(k) accounts to the extent that the participant exercises control over the assets in her 401(k) account).

individual account" and "to choose, from a broad range of investment alternatives."[43] The plan must also provide the participant with "the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan," including information about transaction fees and expenses.[44] Also, "the act of designating investment alternatives in an ERISA Section 404(c) plan is a fiduciary function," and "in deciding whether and to what extent to invest in a particular investment, or to make a particular fund available as a designated investment alternative, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income."[45]

When a plan sponsor allows participants to direct their own investments, the plan sponsor must also choose a default investment for workers who do not otherwise direct their own investments.[46] Historically, plan sponsors used low-yield, stable-value bond funds for that purpose, but the Pension Protection Act of 2006 amended ERISA Section 404(c) to improve the default investments for workers who do not otherwise direct their own investments.[47] That law—and the U.S. Department of Labor's regulation—encouraged employers to replace their low-yield, stable-value bond funds with balanced funds (funds with an unchanging mix of stocks and bonds) and life-cycle funds (funds that gradually shift their investments from stocks towards bonds as workers age).[48] More specifically, the final regulation provides for four types of so-called "qualified default investment alternatives" (QDIAs) and also clarifies that a QDIA may be offered through variable annuity contracts or other pooled investment funds.[49] In response to these rule changes, defined contribution plans have generally moved away from stable-value bond funds and towards target date funds.[50]

Since the promulgation of the QDIA regulation, the government has issued some additional guidance on using annuities in defined contribution plans. For example, IRS Notice 2014-66

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[43] 29 C.F.R. § 2550.404c-1(b)(1).
[44] 29 C.F.R. § 2550.404c-1(b)(2)(i)(B).
[45] U.S. Department of Labor, Pension and Welfare Benefits Administration, Office of Regulations and Interpretations, Advisory Opinion No. 98-04(A) (May 28, 1998).
[46] ERISA § 404(c)(5), 29 U.S.C. § 1104(c)(5).
[47] Pension Protection Act of 2006, Public Law No. 109-280, 120 Statutes at Large 780 (amending ERISA § 404(c), 29 U.S.C. § 1104(c)).
[48] *Id.*; 29 C.F.R. § 2550.404c-5. *See, e.g.*, U.S. Department of Labor, Employee Benefits Security Administration, *Default Investment Alternatives Under Participant Directed Individual Account Plans*, 72 Federal Register 60,452, 60,461 (Oct. 24, 2007), https://www.gpo.gov/fdsys/pkg/FR-2007-10-24/pdf/07-5147.pdf (amending 29 C.F.R. Part 2550).
[49] U.S. Department of Labor, Employee Benefits Security Administration, *Fact Sheet: Regulation Relating to Qualified Default Investment Alternatives in Participant-Directed Individual Account Plans* (Apr. 2008), https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/final-rule-qdia-in-participant-directed-account-plans.pdf.
[50] Andrew Bary, *Target-Date Funds Take Over*, BARRON'S (Jul. 5, 2014), http://www.barrons.com/articles/SB50001424053111904544004579651134019266274; Meaghan Kilroy, *Vanguard finds soaring use of auto enrollment, target-date funds 10 years after PPA*, PENSIONS & INVESTMENTS (Jun. 8, 2016), http://www.pionline.com/article/20160608/ONLINE/160609873/vanguard-finds-soaring-use-of-auto-enrollment-target-date-funds-10-years-after-ppa.

makes it easier for defined contribution plan sponsors to offer annuities.[51] More specifically, if certain conditions are satisfied, plan sponsors can offer, as investment options, a series of target date funds that include deferred income annuities among their assets, even if some of the target date funds within the series are available only to older participants. In a related October 23, 2014 Information Letter, EBSA noted that target date funds that serve as qualified default investment alternatives may include annuities as part of their investment portfolios.[52]

Also, in a December 22, 2016 Information Letter, EBSA told TIAA that its annuity product—the so-called "Income for Life Custom Portfolios" (ILCP)—could still be appropriate for a plan fiduciary to select as a default investment alternative even though it does not specifically fall within the QDIA regulation's safe harbor:[53]

> Whether the selection of any particular investment alternative, including the ILCP, as a default investment alternative satisfies the fiduciary duties of prudence and loyalty in ERISA section 404(a) with respect to any particular plan would depend on the facts and circumstances.[54]

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[51] Notice 2014-66, 2014-46 Internal Revenue Bulletin 820, https://www.irs.gov/pub/irs-drop/n-14-66.pdf.

[52] U.S. Department of Labor, Employee Benefits Security Administration, *Information letter from Phyllis Borzi, Assistant Secretary for the Employee Benefits Security Administration to Mark Iwry, Senior Advisor to the Secretary and Deputy Assistant Secretary for Retirement and Health Policy, U.S. Department of the Treasury* (Oct. 23, 2014), https://www.dol.gov/sites/default/files/ebsa/employers-and-advisers/guidance/information-letters/10-23-2014.pdf.
The letter explains that:

> An "unallocated deferred annuity contract" is a contract with a licensed insurance company that promises to pay income to covered plan participants at some date in the future (possibly far into the future) on a regular basis for a period of time or for life. *Id.* at 2.

The letter concludes that:

> The use of unallocated deferred annuity contracts as fixed income investments, as described in the Notice, would not cause the Funds to fail to meet the requirements of paragraph (e)(4)(i) of the QDIA regulation. The selection of the unallocated deferred annuity contracts satisfies the requirements of section 404(a)(1)(B) of ERISA if the designated investment manager satisfies each of the conditions of the annuity selection safe harbor. The plan sponsor, as the appointing fiduciary, must prudently select the investment manager and monitor the selection at reasonable intervals, in such manner as may be reasonably expected to ensure that the investment manager's performance has been in compliance with the terms of the Plan and statutory standards, and satisfies the needs of the Plan. *Id.* at 4.

[53] U.S. Department of Labor, Employee Benefits Security Administration, *Information letter from Louis J. Campagna, Chief, Division of Fiduciary Interpretations, Office of Regulations and Interpretations for the Employee Benefits Security Administration to Christopher Spence, Senior Director, Federal Government Relations, TIAA* (Dec. 22, 2016), https://www.dol.gov/sites/default/files/ebsa/employers-and-advisers/guidance/information-letters/12-22-2016.pdf. The letter explains that:

> The QDIA regulation, at 29 CFR 2550.404c-5(a)(2) and 2550.404c-5(f)(4), nevertheless states that the QDIA standards are not intended to be the exclusive means by which a fiduciary might satisfy his or her responsibilities with respect to selection of a default investment for assets in the individual account of a participant or beneficiary. *Id.* at 2.

[54] *Id.* at 4.

Also, in 2014, the IRS promulgated final regulations authorizing plans to offer deferred income annuities known as "qualifying longevity annuity contracts" (QLACs).[55] Under the regulations, pension plan participants and IRA holders can spend up to $125,000 on QLACs without running afoul of the required minimum distribution rules that normally require individuals to start taking taxable distributions by age 70½.[56] In that regard, however, a Callan Institute survey of 152 defined contribution plan sponsors in 2017 revealed that none were yet offering QLACs.[57]

Regardless of how participants invest over the course of their careers, at retirement or job separation, a defined contribution plan can offer an in-plan annuity distribution option.[58] To avoid the fiduciary risks that come from selecting and monitoring annuity providers, however, plan sponsors can instead offer annuities outside the plan as an IRA rollover option.[59]

III. Options for Reform

A. The U.S. Department of Labor Should Develop a Workable Safe Harbor for Plan Sponsors to Offer Annuities and Other Lifetime Income Products

As already explained, plan sponsors that offer annuities have fiduciary responsibilities with respect to the selection and monitoring of annuity providers. Plan sponsors can avoid those fiduciary duties if they instead only make lump sum distributions and leave it to the terminating employees to buy their own annuities directly (in after-tax dollars) or, alternatively, indirectly through a rollover IRA (using pre-tax dollars). All in all, the U.S. Department of Labor still has a long way to go in overcoming plan sponsor concerns about offering in-plan annuities without fear of breaching their fiduciary duties.[60] In general, it would be good to reduce these regulatory barriers.

At the outset, the U.S. Department of Labor could clarify the QDIA regulations[61] and also make it much easier for plan sponsors to include annuities in their line-up of QDIA investment alternatives.

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[55] U.S. Department of Treasury, Internal Revenue Service, *Longevity Annuity Contracts*, 79 Federal Register 37,633 (July 2, 2014), https://www.gpo.gov/fdsys/pkg/FR-2014-07-02/pdf/2014-15524.pdf; 26 C.F.R. §§ 1.401(a)(9)-5, A-3 & 1.401(a)(9)-6, A-12.

[56] *See, e.g.*, Jack VanDerhei, *How Much Can Qualifying Longevity Annuity Contracts Improve Retirement Security?*, 36(8) EMPLOYEE BENEFIT RESEARCH INSTITUTE NOTES 10 (2015), https://www.ebri.org/pdf/notespdf/EBRI_Notes_08_Aug15_HSAs-QLACs.pdf.

[57] Callan Institute, *2018 Defined Contribution Trends*, *supra* note 23, at 41.

[58] *See, e.g.*, Steve Utkus, *Annuity—or not?* (Vanguard Blog for Institutional Investors, Nov. 20, 2015), http://vanguardinstitutionalblog.com/2015/11/20/annuity-or-not/.

[59] *Id.*

[60] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-16-433, DOL COULD TAKE STEPS TO IMPROVE RETIREMENT INCOME OPTIONS FOR PLAN PARTICIPANTS 26–32 (2016), http://www.gao.gov/assets/680/678924.pdf. *See also* Utkus, *supra* note 58 ("Concerns about barriers to in-plan annuities have led the Department of Labor to clarify its rules for in-plan annuity selection. So far, the rule clarification hasn't changed employer sentiment."); Jeffrey Brown, *Income As the Outcome: Reframing The 401(k) Plan*, FORBES.COM (Feb. 17, 2014), http://www.forbes.com/.

[61] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-15-578, 401(K) PLANS: CLEARER REGULATIONS COULD HELP PLAN SPONSORS CHOOSE INVESTMENTS FOR PARTICIPANTS (2015), http://www.gao.gov/assets/680/672140.pdf. *See also* U.S. Department of Labor, Employee Benefits Security

Basically, the current QDIA regulations contemplated a world in which plan sponsors let participants change what they are invested in at least once every three months (e.g., from one stock fund to another).[62] Unfortunately, that QDIA condition just will not work with lifetime annuities: annuity providers simply cannot refund premiums, for example, when policyholders discover serious health problems. Nor should annuity providers have to establish that their annuity investment alternatives satisfy the "facts and circumstances" test to otherwise qualify as appropriate default investment alternatives (as was recently suggested in EBSA's December 22, 2016 Information Letter to TIAA).[63] Instead, EBSA should craft a specific safe harbor for annuities and similar life-contingent income streams that relaxes that periodic transfer condition.[64] While some annuity providers do permit transfers from annuity products to other investments,[65] any new QDIA safe harbor for life-contingent products should permit at least some of those products to be nontransferable and nonrefundable.

Also, better guidance on the process of selecting qualifying longevity annuity contracts (QLACs) and other deferred income annuities would increase their utilization.[66]

Basically, most plan sponsors want a workable safe harbor for annuity carrier selection.[67] They want to be able to rely on state insurance regulators and industry standards to oversee and

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Administration, *Fiduciary Relief for Investments in Qualified Default Investment Alternatives* (Fall 2016), https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201610&RIN=1210-AB77 (indicating that EBSA plans to issue a formal request for information about how to amend the QDIA regulations to facilitate the use of lifetime income products).

[62] 29 C.F.R. § 2550.404c-5(c)(5)(i).

[63] U.S. Department of Labor, Employee Benefits Security Administration, *Information letter from Louis J. Campagna, Chief, Division of Fiduciary Interpretations, Office of Regulations and Interpretations for the Employee Benefits Security Administration to Christopher Spence, Senior Director, Federal Government Relations, TIAA*, *supra* note 53.

[64] TIAA, *Closing the guarantee gap: How policymakers can restore the role of lifetime income in workplace retirement plans* 23–24 (2017), https://www.tiaa.org/public/pdf/closing_the_guarantee_gap_whitepaper.pdf (Proposal 3: Broaden the QDIA regulations to further accommodate annuities, both as a component of an existing QDIA option and as QDIA themselves).

[65] U.S. Department of Labor, Employee Benefits Security Administration, *Information letter from Louis J. Campagna, Chief, Division of Fiduciary Interpretations, Office of Regulations and Interpretations for the Employee Benefits Security Administration to Christopher Spence, Senior Director, Federal Government Relations, TIAA*, *supra* note 53, at 2 (explaining that TIAA's Income for Life Custom Portfolio would allow participants to transfer or withdraw funds without restriction for 12 months after the initial investment" and thereafter in installments over an 84-month period).

[66] Ed McCarthy, *Are Retirement Plan Sponsors Too Afraid of Longevity Annuities?*, WEALTHMANAGEMENT.COM (Feb. 10, 2016) http://wealthmanagement.com/retirement-planning/are-retirement-plan-sponsors-too-afraid-longevity-annuities.

[67] *See, e.g.*, MetLife, *Lifetime Income Poll* 6 (2016), https://www.metlife.com/content/dam/microsites/institutional-retirement/pdf/plan-sponsor/income-annuities/LifetimeIncomePoll-exp9-2018.pdf:

> Although today fewer than one in ten plan sponsors say that their 401(k) plan includes a guaranteed lifetime income option, nearly two-thirds of plan sponsors whose plans do not currently include such an option (66 percent) say that they would be at least somewhat likely to make income annuities available to their DC plan participants for their retirement when the DOL completes work on an updated safe harbor rule for the selection of an annuity provider. *Id.* at 7.

monitor annuity providers. That is the way it works in many other countries,[68] and it would probably work in the United States, as well. For example, EBSA (or alternatively, the U.S. Department of Treasury's Federal Insurance Office) could post a list of approved annuities and annuity providers that plan sponsors could use.[69]

Pertinent here, a number of bills in Congress would let plan sponsors rely on representations from insurance companies that their annuities meet state law requirements.[70] To be sure, many analysts believe that EBSA has ample authority to accomplish this kind of change through regulations and does not have to wait for legislation.[71]

The U.S. Department of the Treasury is also interested in encouraging defined contribution plans to offer in-plan annuities.[72]

The U.S. Department of Labor might also encourage plan sponsors to allow for more flexible distribution options. In particular, plan sponsors should be encouraged to offer periodic payments (e.g., monthly distributions) rather than just lump sum distributions. That way participants could try out annuity-like income streams.

The U.S. Department of Labor should also provide guidance to enhance the portability of annuity contracts. There needs to be an easy way for plan sponsors to address periodic changes in their stable of recordkeepers, investment managers, and in-plan annuity providers.[73]

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[68] *See infra* Appendix 1(D); Robert J. Toth, Jr. & Evan Giller, *Regulatory Recommendations for the Department of Labor to Facilitate Lifetime Income*, 3(4) JOURNAL OF RETIREMENT 28, 29–31 (2016).

[69] Insurers interested in having their annuity products on the "qualified" list could be required to formally apply for listing and meet certain solvency and consumer-protection standards. *See also* Abraham & Harris, *The Market for Longevity Annuities*, *supra* note 10, at 22 (suggesting that the government find a way to "certify financial products—including longevity annuities—that meet established standards for reliability, cost, and quality").

[70] *See, e.g.*, Retirement Enhancement and Savings Act of 2018 (RESA), S. 2526, 115th Cong. (introduced by Senator Orrin Hatch [R-UT] on Mar. 8, 2018), https://www.congress.gov/bill/115th-congress/senate-bill/2526 & H.R. 5282, 115th Cong. (introduced by Representative Mike Kelly [R-PA] on Mar. 14, 2018), https://www.congress.gov/bill/115th-congress/house-bill/5282. *See also* Increase Access to a Secure Retirement Act, H.R. 4604 (introduced by Representative Tim Walberg [R-MI] & Representative Lisa Blunt Rochester [D-DE] on Dec. 7, 2017), https://www.congress.gov/bill/115th-congress/house-bill/4604.

[71] *See, e.g.*, TIAA, *Closing the guarantee gap: How policymakers can restore the role of lifetime income in workplace retirement plans*, *supra* note 64, at 23.

[72] *See, e.g.*, U.S. DEPARTMENT OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES ASSET MANAGEMENT AND INSURANCE 10, 141−143 (Oct. 2017), https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf:

> To encourage the availability of in-plan annuity options and promote broader consumer choice, Treasury recommends that the Department of Labor and Treasury develop proposals on how to establish or certify one or more expert, independent fiduciary entities to assess the long-term financial strength of annuity providers. These assessments, which could be in the form of ratings or other specific metrics, could assist ERISA-governed plan sponsors in complying with their fiduciary duty obligations in selecting annuity providers for plans and enable fiduciaries to rely on such assessments as a safe harbor. This independent fiduciary function would not otherwise affect the fiduciaries' ERISA responsibilities to evaluate all other aspects of the annuity purchase decision. *Id.* at 143.

[73] Joanne Sammer, *Risk vs. Readiness: The 401(k) Plan Annuity Conundrum* (Society for Human Resource Management, Feb. 21, 2018), https://www.shrm.org/resourcesandtools/hr-topics/benefits/pages/401k-plan-annuity-

The government might also make it easier to offer annuities outside the plan, through IRA rollovers.[74]

B. The U.S. Department of Labor Should Make It Easier for Plan Sponsors to Provide Financial Advice and Guidance about Lifetime Income Options

Plan sponsors are not required to provide retirement planning advice, and concerns about fiduciary liability may keep them from doing so.[75] Even when employers provide financial education and retirement planning advice, they may not spend much effort explaining annuities and other lifetime income options.[76] The costs of providing such retirement planning advice may also be a problem, particularly for smaller employees. Somehow, the government should make it easier for plan sponsors to provide such financial education and retirement planning advice. In that regard, the U.S. Department of Labor should also encourage plan sponsors to provide retirement income projections to participants on a regular basis.[77]

C. The U.S. Department of Labor Should Broaden the Range of Permissible Lifetime Income Products

The government may also want to broaden the range of permissible lifetime income products that can be offered by defined contribution plans. In particular, one approach is to develop and

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conundrum.aspx; TIAA, *Closing the guarantee gap: How policymakers can restore the role of lifetime income in workplace retirement plans*, *supra* note 64, at 23 (Proposal 2: Enhance the portability of annuity contracts in order to simplify plan operations).

[74] *See, e.g.*, Craig M. Gross & Jonathan R. Kahler, *Perspective on annuities for accumulation in defined contribution plans* 6 (Vanguard Commentary, May 2017), https://institutional.vanguard.com/iam/pdf/ISGAMA.pdf?cbdForceDomain=false.

[75] *See, e.g.*, Noel Abkemeier, Nancy Bennett, Bruno Caron, John Esch, Andy Ferris, Andrew Forgrave, C. David Gustafson, Novian Junus, Barbara Lautzenheiser, Cynthia Levering, Tonya Manning, Mark Shemtob, Kenneth Steiner, Steven Vernon, Zorast Wadia, & Benjamin Yahr, *Risky Business: Living Longer Without Income for Life: Legislative and Regulatory Issues* 2 (American Academy of Actuaries, Oct. 2015), http://actuary.org/files/LegReg_IB_102215.pdf. *See also* Transamerica Center for Retirement Studies, *The Current State of Retirement: A Compendium of Findings About American Retirees* 48 (Apr. 2016), https://www.transamericacenter.org/docs/default-source/retirees-survey/tcrs2016_sr_retiree_compendium.pdf (survey showing that more than 60 percent of employers did little or nothing to help pre-retirees transition into retirement). Pertinent here, the Callan Institute recently reported that 77.1 percent of its surveyed plan sponsors provided retirement income projections in 2016, up sharply from just 56.1 percent in 2015. Callan Institute, *2018 Defined Contribution Trends*, *supra* note 23, at 51.

[76] For example, a 2016 survey of 406 large employers found that just 26.8 percent of those who offered financial/retirement education said they discussed annuities with their employees and plan participants. International Foundation of Employee Benefit Plans, *Financial Education for Today's Workforce: 2016 Survey Results* 20 ex.17 (2016), https://www.ifebp.org/pdf/financial-education-2016-survey-results.pdf.

[77] *See, e.g.*, U.S. Department of Labor, Employee Benefits Security Administration, *Pension Benefits Statements*, 78 Federal Register 26,727 (May 8, 2013), https://www.gpo.gov/fdsys/pkg/FR-2013-05-08/pdf/2013-10636.pdf (Advance notice of proposed rulemaking issued under ERISA § 105, 29 U.S.C. § 1025). *See also* Lauren A. Fleishman-Mayer, Angela Hung, Joanne Yoong, Jack Clift & Caroline Tassot, *Designing Better Pension Benefits Statements: Current Status, Best Practices and Insights from the Field of Judgment and Decisionmaking* (RAND Corporation, Apr. 19, 2013), https://www.dol.gov/sites/default/files/ebsa/researchers/analysis/retirement/designing-better-pension-benefits-statements-current-status-best-practices-and-insights-from-the-field-of-judgment-and-decisionmaking.pdf.

authorize more products that pool risk among participants, as opposed to products that necessitate high premiums to compensate insurance companies for their guarantees and profits. In that regard, for example, TIAA's College Retirement Equities Fund (CREF) has been offering low-cost variable annuities that pool risk among participants for years.[78] Participants choose from various funds to invest in; and later on, they choose from among a variety of distribution options, including one-life and two-life annuities. When a retiree selects a lifetime annuity, the annuity payments depend on both the investment experience of the chosen accounts and the mortality experience of the other participants, but the way these annuities are designed, the mortality risk falls on the annuitants and is not guaranteed by TIAA.

There are many other ideas for lifetime income products that could share longevity risk among participants.[79] For example, so-called "defined-ambition plans"—like those in operation in the Netherlands—offer a way to share risk among plan participants.[80] Also, as more fully explained in Appendix 2, another approach would be to pool risk among participants with financial products like "tontine annuities" and "tontine pensions."[81]

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[78] James M. Poterba & Mark Warshawsky, *The Costs of Annuitizing Retirement Payouts from Individual Accounts*, in ADMINISTRATIVE ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM 173, 191–198 (John B. Shoven, ed., 2000) (discussing the history and development of individual annuities offered by TIAA); Jonathan Barry Forman & Michael J. Sabin, *Tontine Pensions*, 163(3) UNIVERSITY OF PENNSYLVANIA LAW REVIEW 757, 798 (2015), http://www.pennlawreview.com/print/index.php?id=468. *See Prospectus, College Retirement Equities Fund*, TIAA GLOBAL ASSET MANAGEMENT (May 1, 2017), https://www.tiaa.org/public/pdf/cref_prospectus.pdf (last viewed June 6, 2018) ("Investment in a CREF variable annuity is subject to risk and you could lose money. CREF does not guarantee the investment performance of its accounts, and you bear the entire investment risk." *Id.* at 1).

[79] *See, e.g.*, Catherine Donnelly, *Actuarial Fairness and Solidarity in Pooled Annuity Funds*, 45(1) ASTIN BULLETIN 49 (2015); Raimond Maurer, Ralph Rogalla & Ivonne Siegelin, *Participating Payout Life Annuities: Lessons from Germany* 43(2) ASTIN BULLETIN 159 (May 2013); Robert L. Brown & Tyler Meredith, *Pooled Target-Benefit Pension Plans* (Institute for Research on Public Policy, Study No. 27, Mar. 2012), http://irpp.org/wp-content/uploads/assets/research/faces-of-aging/new-research-article-2/IRPP-Study-no27.pdf.
So-called "variable annuity pension plans" are another product that could help provide lifetime retirement income. Grant Camp, Kelly S. Coffing & Ladd E. Preppernau, *Making the case for variable annuity pension plans (VAPPs)*, Milliman (Oct. 7, 2014), http://us.milliman.com/basic-vapp-benefits/ ("A VAPP is a defined benefit (DB) pension plan where the benefits adjust each year based on the return of the plan's assets, resulting in stable funding requirements."). Another idea would be to modify ERISA to permit employers to offer longevity plans—supplemental defined benefit plans where participation begins at age 45 or later and benefits commence at age 75 or later. William Most & Zorast Wadia, *Longevity Plans: An Answer to the Decline of the Defined Benefit Plan*, 28(1) BENEFITS LAW JOURNAL 23 (2015), http://www.milliman.com/uploadedFiles/insight/2015/longevity-plans.pdf.

[80] A. Lans Bovenberg, Roel Mehlkopf & Theo Nijman, *The Promise of Defined Ambition Plans: Lessons for the United States*, in REIMAGINING PENSIONS: THE NEXT 40 YEARS 215 (Olivia S. Mitchell & Richard C. Shea, eds. 2016); John A. Turner, *Hybrid Pensions: Risk Sharing Arrangements for Pension Plan Sponsors and Participants* (Feb. 2014), https://www.soa.org/files/research/projects/research-2014-hybrid-risk-sharing.pdf; Niels Kortleve, *The "Defined Ambition" Pension Plan: A Dutch Interpretation*, 6(1) ROTMAN INTERNATIONAL JOURNAL OF PENSION MANAGEMENT (Spring 2013), http://www.rijpm.com/admin/article_files/2-Kortleve_The_Defined_Ambition_F2.pdf.

[81] Forman & Sabin, *Tontine Pensions*, *supra* note 78. *See also* Moshe A. Milevsky & Thomas S. Salisbury, *Equitable Retirement Income Tontines: Mixing Cohorts Without Discriminating*, 46(3) ASTIN BULLETIN 571 (Sept. 2016). Tontines are named after Lorenzo de Tonti, the 17th-century Italian banker who came up with the idea.

Pertinent here, government guidance so far has largely focused on fixed annuities. Future guidance should also clearly cover variable annuities. The bottom line is that fixed annuities tend to perform as rather sleepy investments, since the insurance companies that offer them generally invest in bonds in order to responsibly meet their guaranteed income responsibilities.[82] On the other hand, variable annuities allow the annuitant to select from a range of investment options, including stocks and stock funds that may be more attractive to many participants and retirees.

IV. Conclusion

Pensions, annuities, and similar lifetime income products provide the best way to protect against longevity risk, and the government should do what it can to encourage defined contribution plan sponsors to offer more lifetime income options and to encourage employees to elect those options.

MOSHE MILEVSKY, KING WILLIAM'S TONTINE: WHY THE RETIREMENT ANNUITY OF THE FUTURE SHOULD RESEMBLE ITS PAST 42 (2015).

[82] *See*, *e.g.*, Immediate Annuities, *Annuity Rates & Trends (Updated Monthly)*, https://www.immediateannuities.com/annuity-trends/ (last visited June 11, 2018). *See also infra* notes 88−89 and accompanying text.

APPENDIX 1: ADDITIONAL BACKGROUND MATERIAL

A. The Mathematics of Converting a Lump Sum into an Annuity

The mathematics of converting a lump sum into actuarially fair lifetime annuity is pretty straightforward. If an individual has a fixed principal sum to invest today, and we know the interest rate (also known as the discount rate) that she can earn and how long she is expected to live, we can determine the annuity amount that she will receive each period.[83] For example, if an individual has $100,000 to invest in an annuity today, can earn 5 percent interest per year, and can expect to receive 20 annual annuity payments (i.e., live for 20 years), a simple annuity calculator shows that each annual annuity payment would be $8,024.26.[84] Annuities typically make monthly payments, but the mathematical principles are the same for yearly or monthly annuities.

B. Comparing Retail Annuities and Actuarially Fair Annuities

Compared to actuarially fair annuities,[85] retail annuities can be quite expensive. Indeed, experts estimate that the typical insurance company lifetime annuity has a 12 percent "load" factor due to the combination of administrative expenses and adverse selection.[86] That is, the typical retail lifetime annuity provides benefits that are worth just 88 percent of an actuarially fair annuity (i.e., a "money's worth ratio" of 88 percent). Put differently, the payouts from actuarially fair annuities would be around 15 percent higher than what can actually be purchased in current annuity markets.

Basically, individuals are rarely able to purchase actuarially fair annuities in the retail annuities market. In that regard, however, it is worth noting that, in effect, the Social Security system does allow workers to buy actuarially fair lifetime annuities merely by delaying retirement beyond age 62.[87]

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[83] The general formula to solve for the periodic annuity amount is:

$$w = [P(1 + r)^{Y-1}r\,] / [(1 + r)^{Y} - 1]$$

where P is the present value (= starting principal) of a stream of annual withdrawal amounts (w) given an interest rate (r) over a number of Years (Y). *See, e.g.*, Moneychimp, *Annuity*, http://www.moneychimp.com/articles/finworks/fmpayout.htm (last visited June 6, 2018).

[84] *See* Moneychimp, *Annuity Calculator*, http://www.moneychimp.com/calculator/annuity_calculator.htm (last visited June 6, 2018) (starting principal: $100,000.00; growth rate: 5 percent; years to pay out: 20 years; payouts at: the end of each year; to get Annual Payout Amount = $8,024.26).

[85] An actuarially fair annuity is one without insurance agent commissions or insurance company reserves, risk-taking, and profits. *See also* Guan Gong & Anthony Webb, *Evaluating the Advanced Life Deferred Annuity—An Annuity People Might Actually Buy* 1 (Boston College Center for Retirement Research, Working Paper No. 2007-15, 2007), http://crr.bc.edu/wp-content/uploads/2007/09/wp_2007-15.pdf (defining "an actuarially fair annuity as one whose expected return, discounted by an interest rate and annual survival probabilities derived from population mortality tables, equals the premium paid").

[86] *See, e.g.*, MARK J. WARSHAWSKY, RETIREMENT INCOME: RISKS AND STRATEGIES 66 (2012) ("[D]ue to a combination of administrative costs and selection effects, the nominal annuity is assumed to have a money's worth ratio of 0.88, that is, the couple faces a 12 percent load factor on their annuity purchase.").

[87] *See, e.g.*, Kenn Beam Tacchino, David A. Littell & Bruce D. Schobel, *A Decision Framework for Optimizing the Social Security Claiming Age*, 28 BENEFITS QUARTERLY 40 (2012),

Finally, it is worth noting that there are a few other problems with annuity markets in the United States. One problem has to do with the rates of return on annuities. While many analysts believe that stocks do better than bonds in the long run,[88] retail prices for annuities are tied to the relatively low yields that accompany bond rates.[89] That can make annuities relatively unattractive investments compared to stock-based mutual funds.

Another problem is that there is relatively little disclosure of the fees that insurance companies and agents charge for annuities.[90] In the end that means that annuities are sold not bought, and the financial advisers and insurance agents selling annuities "can put their own financial interests ahead of the interests of the person they are advising."[91] In that regard, agents may be motivated to sell products that will generate bigger fees, perks, or even kickbacks.[92]

C. The Demographics of Life Expectancy

While lifetime pensions and annuities offer a great way to protect against longevity risk, annuities may be more valuable for some demographic groups than others. In that regard, life expectancy varies with such demographic factors as gender, income, educational level, and race and Hispanic origin.[93] It is also well established that people with higher incomes tend to live longer than people with lower incomes.[94] All in all, policymakers need to bear in mind that some policies to encourage greater annuitization might have undesirable distributional consequences.

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https://www.iscebs.org/Documents/PDF/bqpublic/bq212f.pdf; Melissa A. Z. Knoll & Anya Olsen, *Incentivizing Delayed Claiming of Social Security Retirement Benefits Before Reaching the Full Retirement Age*, 74 SOCIAL SECURITY BULLETIN 21 (2014), https://www.ssa.gov/policy/docs/ssb/v74n4/v74n4p21.pdf.

88 JEREMY J. SIEGEL, STOCKS FOR THE LONG RUN (5th ed., 2014).

89 Diane Oakley, *Retirement Security Risks: What Role Can Annuities Play in Easing Risks in Public Pension Plans?* 16–17 (National Institute on Retirement Security, Issue Brief, Aug. 2015), https://www.nirsonline.org/wp-content/uploads/2017/07/annuities_aug_2015.pdf.

90 *Id.* at 16; Kelli Hueler, Paula Hogan & Anna Rappaport, *Public Policy and Consumer Disclosure for the Income Annuity Market*, 46 J. MARSHALL LAW REVIEW 3, 795, 807 (2013) (noting that low annuitization rates may indicate problems in the marketplace).

91 Memorandum from Office of Senator Elizabeth Warren, *Villas, Castles, and Vacations: How Perks and Giveaways Create Conflicts of Interest in the Annuity Industry* 2 (Oct. 2015), http://www.warren.senate.gov/files/documents/2015-10-27_Senator_Warren_Report_on_Annuity_Industry.pdf.

92 *Id.* at 2.

93 *See, e.g.*, various sources at National Center for Health Statistics, *Life Expectancy*, http://www.cdc.gov/nchs/fastats/life-expectancy.htm (last updated May 3, 2017).

94 *See, e.g.*, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-16-354, RETIREMENT SECURITY: SHORTER LIFE EXPECTANCY REDUCES PROJECTED LIFETIME BENEFITS FOR LOWER EARNERS 21 (2016), http://www.gao.gov/assets/680/676086.pdf (discussing studies that show that lower-income men approaching retirement live, on average 3.6 to 12.7 fewer years than higher-income men). *See also* Raj Chetty, Michael Stepner, Sarah Abraham, Shelby Lin, Benjamin Scuderi, Nicholas Turner, Augustin Bergeron & David Cutler, *The Association Between Income and Life Expectancy in the United States, 2001–2014*, 315(16) JOURNAL OF THE AMERICAN MEDICAL ASSOCIATION 1750 (Apr. 2016).

D. What We Can We Learn from Other Countries

The demand for and supply of lifetime annuities are consistently low in most of the world, although there are a few notable exceptions.[95] The gold standard is probably the Netherlands, where benefits from occupational pensions must be paid out in the form of an inflation-indexed annuity to qualify for tax benefits.[96]

In many countries, however, participants can choose among lump sum distributions, phased withdrawals, and annuities, just as they often can in the United States. Experiences vary, but there are at least a few countries where participants generally select annuitization. For example, in Switzerland, around 80 percent of retirement savings accumulations are converted to lifetime annuities;[97] and, in Chile, 70 percent of retirees choose lifetime annuitization of their public pension benefits over the phased-withdrawal alternative.[98] On the other hand, annuitization in Australia is extremely rare.[99] For example, in 2012, half of those who accessed their Superannuation Funds took lump sums, and 98 percent of the rest chose phased withdrawal over an annuity.[100] The United Kingdom used to have high levels of annuitization, but it recently

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[95] *See, e.g.*, ROBERT ROCHA, DIMITRI VITTAS & HEINZ P. RUDOLPH, ANNUITIES AND OTHER RETIREMENT PRODUCTS: DESIGNING THE PAYOUT PHASE 179 (2011), https://openknowledge.worldbank.org/bitstream/handle/10986/2272/600520PUB0ID181rement09780821385739.pdf?sequence=1R; Robert Holzmann, *Addressing Longevity Risk through Private Annuities: Issues and Options* (Revised Draft Mar. 30, 2015), http://international-pension-workshop.com/papers-pdf/Holzmann.pdf; Olivia S. Mitchell & John Piggot, *Turning Wealth into Lifetime Income: The Challenge Ahead*, in SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY 63, 68 (Olivia S. Mitchell, John Piggott & Noriyuki Takayama, eds., 2011).

[96] John A. Turner & Nari Rhee, *Lessons for Private Sector Retirement Security from Australia, Canada, and the Netherlands* 20 (National Institute on Retirement Security, Issue Brief, 2013), http://www.nirsonline.org/storage/nirs/documents/International%20Paper/final_international_august_2013.pdf.

[97] Holzmann, *supra* note 95, at 2; Monika Bütler & Federica Teppa, *The Choice between an Annuity and a Lump Sum: Results from Swiss Pension Funds*, 91(10) JOURNAL OF PUBLIC ECONOMICS 1944 (2007), http://www.dnb.nl/en/binaries/Buetler_Teppa_JPub_07_tcm47-172517.pdf.

[98] Holzmann, *supra* note 95, at 2. *See also* Jose Ruiz & Olivia S. Mitchell, *Pension Payouts in Chile: Past, Present, and Future Prospects*, in SECURING LIFELONG RETIREMENT INCOME: GLOBAL ANNUITY MARKETS AND POLICY 106 (Olivia S. Mitchell, John Piggott & Noriyuki Takayama, eds., 2011).

[99] Julie Agnew, *Australia's Retirement System: Strengths, Weaknesses, and Reforms* (Boston College Center for Retirement Research, Issue in Brief No. 13-5, Apr. 2013), http://crr.bc.edu/wp-content/uploads/2013/04/IB_13-5-508.pdf; *The Challenge of Longevity Risk: Making Retirement Income Last a Lifetime* 14 (Australian Actuaries Institute, Institute and Faculty of Actuaries [United Kingdom] & American Academy of Actuaries, Oct. 2015), http://www.actuary.org/files/The-Challenge-of-Longevity-Risk.pdf.

[100] Agnew, *supra* note 99, at 4. Lump sum benefit payments were 51.4 percent of total benefit payments in the year ending June 30, 2015, and 48.6 percent were pension benefits (including phased withdrawals and annuities).

moved away from requiring retirees to purchase annuities,[101] and even more recently, it gave existing annuity holders more freedom to sell their existing annuity contracts.[102]

All in all, there is probably a lot that the United States can learn from other countries about how to help Americans get secure streams of lifetime income. For example, the United States can probably learn from the various strategies that other countries use to increase participants' knowledge and understanding of their spend-down options.[103] Some countries also make it harder for financial advisers to charge high commissions or to offer inappropriate investment advice.[104] Many countries also use incentives and withdrawal rules to help encourage annuitization.[105] For example, in Switzerland, some plans use annuities as the default form of distribution, although participants can opt out.[106] Several countries require participants to meet certain minimum-retirement-income requirements if they want to withdraw all or part of their defined contribution plan assets as a lump sum.[107]

Also, while plan sponsors in the United States have a fiduciary obligation to assess the financial stability of the insurance companies that sell annuities to the plans, plan sponsors in many countries have no such obligation.[108] Instead, plan sponsors in those countries can simply rely on insurance regulators and industry standards to oversee and monitor annuity providers.[109]

E. The Challenges to Annuitization in the United States

There are a number of cultural and economic challenges to increasing annuitization in the United States. In particular, many Americans have simply not saved enough in their retirement plans or otherwise to make annuitization practical. Americans also have a woefully low level of financial literacy, and that limited financial literacy makes it hard for them to conduct meaningful retirement planning.[110] Annuities are particular hard for individuals to understand and

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[101] *See, e.g.*, HM Revenue & Customs, *Pension Flexibility 2016* (Mar. 16, 2016), https://www.gov.uk/government/publications/pension-flexibility-2016; Joseph A. Tomlinson, *Eyewitness to History in the UK*, RETIREMENT INCOME JOURNAL, Mar. 20, 2014, http://retirementincomejournal.com/issue/march-20-2014/article/eyewitness-to-history-in-the-uk.

[102] *See, e.g.*, Tanya Jefferies, *Five million pensioners given chance to offload unwanted annuities for cash from April 2017*, THIS IS MONEY, Dec. 15, 2015, http://www.thisismoney.co.uk/money/pensions/article-3360602/Pensioners-given-chance-offload-unwanted-annuities-cash-April-2017.html; *Existing pensioners to be allowed to 'sell' annuities from 2016, UK government announces*, OUT-LAW.COM, Mar. 17, 2015, http://www.out-law.com/en/articles/2015/march/existing-pensioners-to-be-allowed-to-sell-annuities-from-2016-uk-government-announces/.

[103] *See, e.g.*, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-14-9, 401(K) PLANS: OTHER COUNTRIES' EXPERIENCES OFFER LESSONS IN POLICIES AND OVERSIGHT OF SPEND-DOWN OPTIONS 24–32 (Nov. 2013), http://www.gao.gov/assets/660/659169.pdf.

[104] *Id.* at 34.

[105] *Id.* at 32–33, 35–37.

[106] *Id.* at 32.

[107] *Id.* at 35.

[108] *Id.* at 37–39.

[109] *Id.*

[110] *See, e.g.*, Annamaria Lusardi & Olivia S. Mitchell, *The Economic Importance of Financial Literacy: Theory and Evidence*, 52(1) JOURNAL OF ECONOMIC LITERATURE 5 (2014), *available at*

appreciate.[111] For example, individuals often underestimate their life expectancies and overvalue the modest lump sums that they have accumulated.[112]

APPENDIX 2: TONTINE ANNUITIES AND TONTINE PENSIONS

With the decline of defined benefit plans and the unpopularity of annuities, new lifetime income products may be needed to take their place. In particular, this Appendix explains how tontine annuities, tontine pensions, and survivor funds could be used to provide life-contingent income streams.[113]

A. Tontine Annuities

In a simple tontine, members contribute equally to buy a portfolio of investments that is awarded entirely to the last surviving member. Alternatively, each time a member of a tontine pool dies, her account balance could be divided among the surviving members of the pool. This latter type of tontine could be used to develop new financial products that would provide reliable pension-like income.

For example, in a tontine annuity, the mortality gains that would arise as members of the pool die would not be divided among the survivors immediately. Instead, the mortality gains would be allocated to the individual accounts of the survivors. If a pool member is alive at the end of the month, she would be paid the accrued mortality gains in her account as a monthly "mortality-gain distribution." On the other hand, if she is not alive at the end of the month, she would receive nothing, as the balance in her account, including any mortality gains accrued earlier in that month, would have been distributed to the accounts of the surviving members when she died.

In addition to receiving a monthly mortality-gain distribution, each survivor would also receive a portion of her original contribution at the end of each month she is alive. The resulting tontine annuities could be designed to have monthly benefits that are level throughout retirement (like an immediate, level-payment annuity) or, alternatively, that increase gradually throughout retirement (like an immediate, inflation-adjusted annuity).

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https://pensionresearchcouncil.wharton.upenn.edu/wp-content/uploads/2015/11/JEL_FinLit_LusardiMitchell2-12-14.pdf; U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-16-242, RETIREMENT SECURITY: BETTER INFORMATION ON INCOME REPLACEMENT RATES NEEDED TO HELP WORKERS PLAN FOR RETIREMENT 4–5 (2016), http://www.gao.gov/assets/680/675526.pdf.

[111] *See, e.g.*, John Beshears, James J. Choi, David Laibson, Brigitte C. Madrian & Stephen P. Zeldes, *What Makes Annuitization More Appealing?*, 116 JOURNAL OF PUBLIC ECONOMICS 2 (Aug. 2014), *available at* http://www.sciencedirect.com/science/article/pii/S004727271300114X.

[112] *See, e.g.*, Society of Actuaries, *Key Findings and Issues: Longevity: 2011 Risks and Process of Retirement Survey Report* 4, 6 (June 2012), https://www.soa.org/research/research-projects/pension/research-post-retirement-needs-and-risks.aspx (finding that more than half of survey respondents underestimated population longevity); Roberta Rafaloff, *Testimony for the ERISA Advisory Council on Model Notices and Disclosures for Pension Risk Transfers* (May 28, 2015), http://www.dol.gov/ebsa/pdf/erisaadvisorycouncil2015risk8.pdf (noting that "participants tend to underestimate future income needs and overestimate the wealth effect a lump sum offer conveys").

[113] *See, e.g.*, Michael J. Sabin, *Fair Tontine Annuity* (March 26, 2010), *http://ssrn.com/abstract=1579932*; Forman & Sabin, *Tontine Pensions*, *supra* note 78; Jonathan Barry Forman & Michael J. Sabin, *Survivor Funds* 37(1) PACE LAW REVIEW 204 (Fall 2016), http://digitalcommons.pace.edu/plr/vol37/iss1/7/.

In theory, a tontine annuity could be managed by a discount broker, and no money would have to be set aside for insurance agent commissions or for insurance company reserves, risk-taking or profits. All in all, with such low fees, the benefits from a tontine annuity would closely approximate those of an actuarially fair annuity.

Moreover, unlike traditional tontines, tontine annuities could solicit new investors to replace those members who have died. Structured in this way, a tontine annuity could operate in perpetuity.

B. Tontine Pensions

While tontine annuities would be attractive investments in their own right, they are likely to be as underutilized as traditional retail annuities. Individual investors generally underestimate their life expectancies, and they shy away from lifetime annuities. That is where tontine pensions could be especially beneficial.

For example, an employer who wanted to provide a lifetime retirement income for its employees might set up a defined-contribution-style "tontine pension," only instead of investing the employer contributions in stocks and bonds, the employer would invest in a tontine annuity for its employees. Each year, the employer could make contributions of, say, 10 percent of its employees' salaries. Those contributions would be invested in a tontine annuity and allocated to the individual tontine pension accounts of the participants. At retirement, the balance in each participant's tontine pension account would be paid out to her in the same manner as if she had purchased her very own tontine annuity with the employer contributions made on her behalf.

In effect, a tontine pension would be like a defined contribution plan that only pays benefits in the form of a lifetime annuity. Rather than getting lump-sum or periodic distributions, participants in this plan could only get benefits based on the survivor principle. That is, the employer contributions for each participant and the investment earnings on those contributions would be held in the tontine pension and monthly tontine-pension distributions for life would be the only distributions retirees could ever receive.

C. Survivor Funds

Survivor funds would work like short-term tontines. Basically, survivor funds would be short-term investment funds that would favor investors who live until the end of the fund's term over those who die before then. For example, imagine that 10 65-year-old male participants each invest $8,000 in a pool that buys 10-year Treasury bonds. At the current Treasury interest rate, that $80,000 investment would return about $100,000 in 10 years, and each participant (or his heirs) would get $10,000, reflecting a pitiful 2.3 percent yield. But what if we instead divided that $100,000 only among the participants who survived 10 years to reach age 75? Say eight of our 10 participants lived to 75. With a survivor fund, those eight survivors would divide the $100,000, and the two participants who died would get nothing. In short, each survivor would get $12,500 on his $8,000 investment—and that works out to be a 4.6 percent return, double the meager 2.3 percent return on the underlying zero-coupon bond.[114]

Survivor funds would be attractive investments because the survivors would get a greater return on their investments, while the decedents, for obvious reasons, would not care. And even if no other investors died during the term of the fund, the survivors would never get less than the return on the underlying investment. Administrative fees would be low, and the returns for survivors would be high; and that would deliver exactly what many of today's retirees want.

[114] Moreover, the returns could be even higher if the survivor fund invests in stocks instead of bonds. For example, if our hypothetical survivor fund had instead invested in a Standard & Poor's 500 index fund that earned, say, 7 percent, the survivors would get 9.4 percent. If that S&P 500 index fund earned 10 percent, the survivors would get 12.5 percent.