Advisory Council on Employee Welfare and Pension Benefit Plans

Report to the Honorable R. Alexander Acosta, United States Secretary of Labor

Lifetime Income Solutions as a Qualified Default Investment Alternative (QDIA) – Focus on Decumulation and Rollovers

November 2018

NOTICE

The Advisory Council on Employee Welfare and Pension Benefit Plans, usually referred to as the ERISA Advisory Council (“the Council"), produced this report. The Council was established under section 512 of ERISA to advise the Secretary of Labor on matters related to welfare and pension benefit plans. This report examines lifetime income in defined contribution pension plans. To distinguish the Council considering this topic from prior Councils considering a similar issue, the 2018 Council will be referred to hereafter as “the 2018 Council.”

The contents of this report do not represent the position of the Department of Labor.

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ABSTRACT

The 2018 Council's objective was to focus recommendations on promoting lifetime income (LTI) within defined contribution (DC) plans through changes to the annuity selection safe harbor and modifying the Qualified Default Investment Alternative (QDIA) rule to focus on asset accumulation and decumulation issues in the context of LTI needs and solutions. The 2018 Council's intention was to complement previous efforts and not duplicate them. The 2018 Council heard witness testimony that included recommendations on defining the QDIA, porting LTI solutions, understanding opportunities and challenges with target date funds (TDFs) as they apply in accumulating and decumulating assets, and new or innovative solutions and approaches to addressing LTI.

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I. EXECUTIVE SUMMARY

The 2018 Council's objective was to make recommendations on promoting LTI within DC plans through providing further guidance on an annuity selection safe harbor and modifying the QDIA rule to focus on asset accumulation and decumulation issues in the context of LTI needs and solutions. The 2018 Council's work expanded on the findings of prior Council reports: *Spend Down of Defined Contribution Assets at Retirement* (the 2008 Report), *Examining Income Replacement During Retirement Years in a Defined Contribution Plan System* (the 2012 Report), *Issues and Considerations Surrounding Facilitating Lifetime Plan Participation* (the 2014 Report) and *Participant Plan Transfers and Account Consolidation for the Advancement of Lifetime Plan Participation* (the 2016 Report). To this end, the 2018 Council asked witnesses to focus and comment on the following:

- Defining the QDIA,
- Porting LTI solutions,
- Identifying opportunities and challenges with TDFs as they apply in accumulating and drawing down assets, and
- Addressing LTI with new or innovative solutions / approaches.

The 2018 Council heard from witnesses who reflected DC plan participants' and retirees' perspectives on their need for LTI and the diversity of participants' circumstances. Witnesses with expertise in the fields of personal and behavioral finance described behavioral impediments to certain LTI products. They also discussed the importance of framing LTI discussions, so negative perceptions do not overshadow LTI solution benefits. Plan sponsors and firms that represent plan sponsors shared their views on opportunities and challenges associated with incorporating LTI within DC plans and QDIAs. ERISA experts advising plan sponsors and firms selling LTI products testified on the legal framework for LTI in DC plans. Firms that have developed or are developing new LTI products shared their experiences, particularly regarding DC plans. LTI product platform providers, including DC plan recordkeepers, testified on key implementation and portability issues.

Based upon testimony received during two days of hearings supplemented by written material submitted from interested stakeholders, the 2018 Council observed:

- No single product or plan design is likely to address decumulation needs for all DC plan participants. This issue arises from differences in general financial circumstances, account sizes, assets held outside of plans, health profiles, age, gender and marital status. To meet these variable needs, plans may need different solutions.
- Plan sponsors may be deterred from incorporating LTI features within QDIA options because QDIA regulations remain ambiguous in several areas, including liquidity requirements and the ability to limit participation to particular demographic groups, e.g., participants of a specific age or length of service.
- Plan sponsors remain challenged in incorporating LTI options due to fiduciary concerns around selecting and monitoring an annuity issuer. Plan sponsors generally seek an

objective and uniformly applied safe harbor. No witnesses before the 2018 Council suggested standards for such a safe harbor. Several witnesses broadly supported potential and pending legislative proposals that would materially modify the fiduciary framework; however, this legislation is beyond the 2018 Council's scope and remit.

- Inconsistencies and disparities across LTI products and administrative platforms hinder LTI utilization.
- As discussed in prior Councils' reports, participants would benefit from clear and unbiased education and information related to DC plan asset decumulation strategies. Plan sponsors may be more inclined to provide this information if they were certain that providing such information would not constitute investment advice.
- The complexity of the LTI topic masks the fact that plan design offerings, such as a social security bridge option or installment payout, could be accommodated today on most recordkeeping platforms at limited cost.

The QDIA regulations tangentially address LTI and the Department's guidance has generally been informal. The 2018 Council concluded that amending QDIA regulations to specifically address LTI could incent plan sponsors to adopt innovative QDIAs, including QDIAs with LTI options.

The 2018 Council believes that plan sponsors could benefit from using independent fiduciary experts to manage fiduciary liabilities associated with providing LTI options. Specifically, applying the fiduciary responsibility scheme of ERISA section 3(38) in which the plan fiduciary only has responsibility for the prudent selection and monitoring of an independent expert would address many plan sponsor concerns about fiduciary liability. To this point, the 2018 Council believes that clarifying a sponsor's ability to delegate fiduciary responsibilities in selecting LTI distribution options, including annuities, to a 3(38) investment manager would be useful in incenting plan sponsors to adopt LTI options. The 2018 Council further notes that this guidance could facilitate creating annuity purchase platforms within the ERISA framework, as opposed to individual retirement account (IRA) annuity purchase platforms.

The 2018 Council further concluded that plans offering different kinds of distribution options could have a positive material impact on participants' retirement income. Including these distribution options are settlor decisions and these options are readily available on most recordkeeping platforms at modest cost. Despite these points, the 2018 Council understands that many plans continue to offer only a single sum distribution option. The 2018 Council believes that more plan sponsors would adopt multiple distribution options if the Department clarifies that offering multiple distribution options is a business decision made in a settlor capacity and this decision is exempt from fiduciary liability.

Based on the testimony, the 2018 Council made recommendations to the Department in the areas of:

1. Amendments to the QDIA regulations
2. Delegation of fiduciary responsibilities for annuity selection
3. Plan distribution options

II. RECOMMENDATIONS

The Council recommends the Department:

1. Amend the QDIA regulations to address using LTI in a QDIA. Such changes should:
   a. Address the permissibility of including fixed annuities, living benefits and other LTI approaches in a QDIA;
   b. Address the importance of tailoring QDIA options to affected participants, similar to rules applicable to QDIA balanced funds. Specifically, we recommend the Department clarify that sponsors may default participants into different options based on participant demographics because plan populations may not be sufficiently similar for a single default to be universally appropriate;
   c. Maintain the current transferability and liquidity requirements, but clarify whether living benefits satisfy these requirements;
   d. Address the extent to which charges may be imposed if they have the effect of limiting liquidity and/or transferability.
2. The Department should publish guidance confirming that a named plan fiduciary may appoint a 3(38) investment manager to select and monitor annuity and other LTI providers for DC plan decumulation, as well as accumulation.
3. The Department should encourage plan sponsors to adopt plan design features that facilitate LTI, including, but not limited to: allowing participants to take ad hoc distributions, enabling installment payments, providing social security bridge options and allowing for payment of required minimum distributions.

III. BACKGROUND – Prior Council Reports

Four prior councils have studied LTI. The 2018 Council intends to complement previous efforts, not duplicate them.

A. The 2008 Council Report

The 2008 Council's report discussed plan design barriers to incorporating LTI options in DC plans. These hindrances included:

- Fiduciary liabilities associated with choosing an LTI provider,
- LTI options' irrevocability,
- LTI options' administrative complexity,
- Negative impressions about annuities' and other guaranteed products' usefulness arising from the QDIA regulations, and
- Spousal consent requirements for plans offering life annuity options.

The 2008 Council recommended updating, expanding and amending Interpretative Bulletin 96-1 by adapting the bulletin to the spend-down phase, stating:

> *"IB 96-1 needs to address information, education, and advice related to the spend-down of retirement plan assets (distribution options, in-plan vs. out-of-plan payments) as well as the accumulation of those assets. Plan sponsors need clear guidance about the type of information, programs and education they may provide to participants, without being concerned that they are acting as a fiduciary providing investment advice or that they may be exposed to liability for breach of their fiduciary duty. Further, as product innovation continues in this area, 96-1 needs to be continually updated. This same recommendation was made by the 2007 Council that studied Financial Literacy."*

Additionally, the 2008 Council recommended that the Department clarify that products eligible as QDIAs while participants are contributing continue to qualify as QDIAs when participants are drawing down their assets, if the sponsor retains the investment products in the plan. The 2008 Council also recommended simplifying annuity provider selection rules, but acknowledged that those issues were substantively addressed when the Department published final regulations on the topic in October 2008.

B. The 2012 Council Report

The 2012 Council addressed the shift from traditional defined benefit (DB) plans to DC plans as a primary source of retirement income and the resulting need for additional options to help secure participants' retirement security and reduce risks of outliving income or not maintaining a certain lifestyle during retirement. The 2012 Council examined income replacement in a retirement system predominantly underpinned by DC plans with a focus on understanding:

1. Participant challenges,
2. Alternative options available to create LTI,
3. Plan sponsors' considerations and challenges in making lifetime solutions available, and
4. Plan sponsors' considerations and challenges in educating participants about LTI.

The 2012 Council, for example, received testimony and materials on participant educational materials to assist them in evaluating and selecting income replacement options. The 2012 Council noted that retirement income products and solutions were continuing to evolve. The 2012 Council specifically considered five kinds of income products and solutions: fixed annuities, guaranteed minimum withdrawal benefits (GMWBs), longevity insurance, managed payout and retirement income mutual funds, and managed retirement accounts.

The 2012 Council had two recommendations relevant for the 2018 Council's work. First, the 2012 Council recommended that the Department enhance regulatory and sub-regulatory guidance to help plan sponsors address fiduciary concerns associated with offering income replacement options or advice on available options. The 2012 Council focused primarily on a safe harbor for annuities; however, the 2012 Council also recognized that sponsors would need additional guidance to address the evolving solution set. The 2012 Council further recommended the Department create educational materials for employers, sponsors and employees to use in

evaluating and selecting retirement income options. The 2012 Council urged the Department to develop more definitive guidance on safe harbor provisions in Regulation Section 2550.404a-4. The 2012 Council believed that partnering with state-based insurance associations, such as the National Association of Insurance Commissioners (NAIC), would help the Department in developing a more workable safe harbor for annuities and LTI product selection.

The 2012 Council laid out several alternatives available to plan sponsors and participants as a means of income replacement, including the following:

- Fixed Life Annuities
- Variable Life Annuities
- Fixed Period Annuities
- Systematic Withdrawals
- Interest-Only Withdrawals
- Longevity Insurance
- Guaranteed Lifetime Withdrawal Benefit (GLWB)
- Guaranteed Minimum Income Benefit (GMIB)
- GMWB
- Target Income or Managed Payout Funds
- Lump Sum Payouts

The 2012 Council recognized that LTI required cooperation between plan sponsors and participants. The 2012 Council believed that guidance through education would benefit participants but plan sponsors' fiduciary responsibilities remained an issue and barrier to providing such education. The 2012 Council recommended that the Department:

> *"…review, modify, and or develop regulatory guidance/clarification with respect to decumulation of retirement assets, including a defined contribution plan annuity safe harbor, participant education, and investment advice."*

The 2012 Council further recommended that the Department develop educational materials to assist employers and plan sponsors in evaluating and selecting income replacement options, as well as aiding individuals in choosing income replacement options best suited their retirement needs.

C. The 2014 and 2016 Council Reports

The 2014 and 2016 Councils focused on lifetime plan participation, exploring the following:

1. Problems associated with keeping assets in employer-sponsored DC plans during retirement,
2. Portability challenges preventing assets from moving between plans, and

3. Limitations and inconsistencies between solutions / approaches across the retirement system.

The 2014 Council concluded that workers' choices can have a significant impact on their financial well-being in retirement and leakage from retirement plans was leaving workers with insufficient retirement income. The 2014 Council determined that offering LTI options would be an incentive for participants to remain in a plan when their employment status changed. Witnesses testifying in front of the 2014 Council confirmed that the fiduciary issues and safe harbor recommendations with regard to LTI solutions and annuities from the 2012 Council remained relevant.

The 2016 Council's work focused on structural rigidities preventing efficient asset consolidation within qualified plans, and plan-to-plan transfers. The 2016 Council did not make recommendations particular to LTI options; however, the 2016 Council's work demonstrated an administrative need for making portable, effective LTI solutions available to savers. The 2016 Council further recommended that procedural complexity in making transfers should be considered in designing LTI options.

IV. DISCUSSION

A. Introduction

The private U.S. retirement system continues to shift more responsibility toward individuals via DC plans and IRAs. This trend has largely focused attention on individuals' asset accumulation with more limited attention on understanding, facilitating and/or educating people on decumulation or the spend-down phase of retirement. This shift poses several challenges for individuals, including:

- Ensuring they accumulate sufficient assets,
- Managing investment and inflation risks in line with expected longevity,
- Aligning spending with income to ensure retirement savings last throughout their lifetime, and
- Making critical decisions ahead of cognitive decline in their later years.

With the enactment of the Pension Protection Act (PPA) and QDIA regulations, assets within DC plans have shifted significantly toward QDIA offerings, TDFs in particular. One recordkeeper estimated that just over 50 cents of each dollar contributed to a DC plan is directed to the plan's QDIA.[1] To a large extent, this shift results from plan sponsors adopting automatic enrollment and auto-escalation features.

Given QDIA assets are significant and continue to be the primary option in which participants accumulate assets, the 2018 Council studied the LTI landscape with the goal of recommending approaches to encourage plan sponsors to adopt LTI elements within DC plans, placing specific emphasis on including these options within QDIAs. According to a 2016 GAO report

[1] Croke testimony.

approximately 25% of plans offer some type of annuity solution to participants. The most common annuities available in DC plans are fixed immediate annuities (14% of all plans), followed by annuities with a GLWB or GMWB (10% of all plans), and deferred annuities (less than 1% of all plans).[2]

The 2018 Council also sought to identify and examine challenges embedded in the current framework that inhibit plan sponsors from offering LTI features.

The 2018 Council heard testimony and questioned witnesses in the following areas:

- **Participant Considerations:** What are the current economic and market environments? Is there a demonstrated need for LTI features for participants in DC plans? In developing and promoting LTI features, how should plans address the participant diversity with respect to their individual circumstances (e.g., age, income, gender, health, account balance, other financial assets/income and obligations accumulated outside of the plan, access to DB plans and Social Security, etc.)? What behaviors drive participants' acceptance or rejection of LTI offerings?

- **Plan Sponsor Considerations:** How might plan sponsors benefit from incorporating LTI in their plans and QDIAs? Do employees enter retirement confidently? Are their savings patterns different? Do they retire "on time"? What are the deterrents to adoption of LTI features in a QDIA? What are plan sponsors' concerns around fiduciary issues, product complexity, and participant communications? How can plan sponsors ensure that selection criteria for LTI products and features meet the standards embedded within ERISA?

- **Lifetime Income Solutions:** What is the definition of LTI? How can LTI features be incorporated within a QDIA to enhance participant financial well-being in retirement? What product types incorporate LTI features and how might those products impact financial outcomes? How can LTI products be compared in terms of cost and product viability? How should LTI products be assessed in the context of other participant income sources? What are the logistical challenges within the recordkeeping environment that mitigate full utilization of LTI products?

The 2018 Council researched and examined the statutory history and regulations around LTI products within DC plans to understand the background and current parameters for such features. Witnesses provided background on the PPA, the Department, QDIA regulations, annuity safe harbor guidance and other Department communications that create the LTI product framework. Witnesses pointed to opportunities and challenges in encouraging LTI adoption within qualified plans and made recommendations around the regulatory framework to facilitate plan sponsors adopting LTI options.

Witnesses shared their views, statistics and forecasts of LTI needs and participant demand, including survey data and projected retirement income adequacy models. Several witnesses cited

[2] Government Accountability Office, GAO-16-433, 401(K) PLANS DOL Could Take Steps to Improve Retirement Income Options for Plan Participants (2016), page 19.

considerable difficulty in developing universal LTI strategies due to differing participant characteristics, for example wealth levels or health risks.

Firms developing and marketing LTI products provided the 2018 Council with their perspectives on LTI options and features to consider when incorporating LTI in DC plans and QDIAs. This research included information on products and designs on platforms not currently included in qualified plans. These discussions highlighted the breadth of current and potential marketplace solutions. The recommendations consider the evolving product landscape to include future viable solutions.

The 2018 Council also heard testimony regarding LTI options' liquidity, flexibility, costs, portability, recordkeeping challenges and implementation timing. Several witnesses urged the 2018 Council to consider how decumulation strategies interact across retiree income sources including Social Security, defined benefit plans, etc. Additionally, witnesses cautioned the 2018 Council to consider unintended consequences that might constrain participants' need for future liquidity and financial flexibility.

Some witnesses highlighted plan sponsors' deterrents from including LTI in DC plans or QDIAs: fiduciary risk, low participant demand, a mobile workforce, and adding and monitoring additional fund options. Other witnesses pointed to the historical framing of LTI products and behavioral reasons for limited demand, e.g., loss of control, complexity, etc. One plan sponsor that had implemented LTI within a QDIA described the benefits to participants and the plan sponsor. Several witnesses noted simple plan design solutions to facilitate LTI strategies.

Witnesses, including DC plan administrators, also discussed infrastructure for supporting and incorporating LTI products. The industry is working toward standards for supporting products; however, operating inconsistencies among products present challenges. Further, administrators have varying operating environments and different abilities to accommodate the various LTI structures, which constrains portability across platforms. Portability is problematic when plan sponsors change recordkeepers or have mergers.

Included as Appendix B is a glossary of LTI-related terms used within this report.

B. Retiree Income Needs

Retirees in the U.S. rely on Social Security, money accumulated in employer-sponsored savings programs and retirement plans, individual savings pre- and post-tax, and equity accumulated in homes, businesses and properties to provide income in retirement. Most policy efforts have primarily focused on helping individuals accumulate wealth versus turning this wealth into an income stream in retirement.

Currently in the U.S., private sector retirement plans are predominantly DC plans. Private sector DC plans held $5.8 trillion as of the start of 2018, while private-sector DB plans held only $3.1

trillion.[3] Additionally, due to rollovers from DC plans, IRAs[4] are now the largest component of the U.S. retirement system. The typical DB plan provides participants with a lifetime regular income source similar to an annuity. In a DC plan, as discussed below, the ability to convert the accrued savings into a regular income source option is the rare exception rather than the norm. The shift away from DB plans has resulted in Social Security retirement benefits becoming the only source of guaranteed retiree LTI for many people. Furthermore, the decline in DB plan sponsorship and accompanying shift to DC plans and or IRAs means individuals are fundamentally responsible for transforming accumulated savings into income. To achieve this goal, participants must manage investment, inflation and longevity risks. These risks and managing them effectively are critically important to maintaining financial security, as Americans now can expect to live at least 20 to 30 years in retirement.

Regardless of savings levels and income needs, many witnesses testified that retirees are concerned about outliving their savings, which can lead to hoarding and underspending.[5] In a study published in April 2018, the Employee Benefits Research Institute (EBRI) found that retirees generally have very slow asset decumulation and 33% of retirees surveyed increased non-housing assets in the first eighteen years following retirement.[6] Consequently, even when retirees already have sufficient assets to meet their retirement income needs, LTI options may alleviate anxiety and address underspending.

Understanding and measuring retiree income needs are difficult, because their stated interest in guaranteed income products diverges from actual usage. Michael Hadley of Davis & Harman LLP noted:

> *"There is significant evidence that retirees are anxious about their ability to make their savings last, and that plan sponsors are concerned about offering their employees the right tools to help them. EBRI's most recent survey finds that eight in ten workers are very or somewhat interested in an in-plan investment option that would guarantee monthly income for life at retirement* [7] ***…*** *Nearly half (44%) of plan sponsors in [their] 2012 survey said that the majority of their DC plan participants would prefer to 'receive at least part of their retirement savings as monthly income for as long as they live rather than receiving all of it in a lump sum that they would invest themselves. Retirees similarly show a disconnect between their reported interest in guaranteed income products and the use of these products. Earlier EBRI surveys find that nearly half of workers report that they are 'very likely' or 'somewhat likely' to purchase a guaranteed income product at*

[3] Investment Company Institute, *Release: Quarterly Retirement Market Data, First Quarter 2018, https://www.ici.org/research/stats/retirement/ret_18_q1*.

[4] Investment Company Institute, *"The Role of IRAs in U.S. Households' Saving for Retirement"*, December 2017.

[5] Ghilarducci testimony.

[6] EBRI, *"Asset Decumulation or Asset Preservation? What Guides Retirement Spending?"* April 2018.

[7] EBRI, The 2018 Retirement Confidence Survey, https://www.ebri.org/pdf/surveys/rcs/2018/2018RCS_Report_V5MGAchecked.pdf.

> *retirement… only 12% actually…purchase…a guaranteed income product at retirement.*[8] *Similarly, when defined benefit plans offer a lump sum, a significant majority of employees elect a lump sum."*[9]

Michael Finke from the American College for Financial Service noted that 92% of surveyed individuals express an interest in converting at least some existing savings into guaranteed income. Additionally, Marc Pester of Prudential Retirement, citing a Harris Poll conducted on behalf of Prudential Financial, testified that maintaining lifestyle throughout retirement and not running out of money during retirement are the two most commonly cited financial retiree priorities[10]. This testimony underscores the disconnect between desire for regular income benefits and the low percentage of participants actually purchasing products that deliver these benefits, as described in Section C, below.

Overall, DC plan participants and retirees[11] have significantly varying income needs. This diversity complicates decision-making for employers, especially if the LTI solution is a one-size-fits-all default, e.g., a TDF, not related to an individual's attributes. Participants and retirees clearly need LTI solutions focused on their particular circumstances. The current QDIA framework does not adequately address the extent to which a plan sponsor may select different types of QDIAs for different groups of participants.

C. LTI Solutions

The 2018 Council heard testimony from industry experts on the prevalence of LTI solutions in DC plans, forecasted retirement outcomes with embedded annuities, infrastructure challenges supporting guaranteed products, out-of-plan solutions, and plan design strategies focused on addressing LTI.

- **Summary**

LTI solutions can be grouped into two primary categories: those providing some level of guaranteed income for life, i.e., a fixed distribution amount, and those that pay out income based on other factors, i.e., a variable distribution amount based on investment returns. LTI solutions can be contractual or take the form of a distribution from accumulated assets. LTI solutions embodied as a contract are most frequently in the form of an annuity. Guaranteed and non-guaranteed LTI strategies are not mutually exclusive and can be combined to generate a retirement income strategy.

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[8] EBRI, The 2012 Retirement Confidence Survey 28 (2012), available *at* http://www.ebri.org/pdf/surveys/rcs/2012/EBRI_IB_03-2012_No369_RCS.pdf.

[9] Government Accountability Office, GAO-09-642, Private Pensions: Alternative Approaches Could Address Retirement Risks Faced by Workers but Pose Trade-offs 19-20 (2009).

[10] Pester testimony.

[11] Croke testimony.

Immediate annuities provide income directly upon purchase and have been available in one form or another for thousands of years[12]. GMWBs or GLWBs provide a minimum income level for life, where the income amount can potentially increase based on performance of an underlying investment portfolio and contractual provisions.

Deferred annuities are contracts that pay an agreed amount starting at a future date e.g., starting 10 years after the contract is purchased. Contracts where income commences at advanced ages, e.g., age 80 or beyond, are commonly referred to as longevity insurance. A Qualified Longevity Annuity Contract (QLAC) is a deferred annuity with specific restrictive provisions. Annuities can be purchased in a DC plan as part of a rollover transaction where the purchase is linked to the DC plan, but is bought in an individual account, e.g., an IRA; or outside a plan sponsor's sphere of influence. Individuals purchasing annuities outside of a plan or plan sponsor's platform is relatively uncommon.[13]

Non-guaranteed LTI strategies are typically pre-packaged multi-asset class solutions, such as TDF retirement vintages or a managed payout fund. Other non-guaranteed LTI options create retiree-focused portfolios using investment options in the core fund line-up, e.g., an inflation-protected investment option. Participants can also create portfolios using an in-plan advice tool or solution, such as managed accounts, or with an investment advisor's help.

See Section V, Part A for additional information, as well as advantages and disadvantages of some of these approaches.

- **Annuities**

Annuities are the most well-known and prevalent forms for securing LTI. In 2017, total annuity sales in the U.S. were $192.1 billion, according to Beacon Research and Morningstar, Inc. Of that total, 2017 variable annuity sales were $90.3 billion.[14] Despite the fact that the U.S. has a well-developed market for annuities, the penetration rate is fairly low overall; for example, annuities represented just 8 percent of retirement assets in 2016.

A critical question is whether low annuity demand results from individuals rationally deciding that their retirements are financially secure in the long term. According to Pashchenko and Porapakkarm,[15] Social Security guarantees a portion of most individuals' retirement income. The unwillingness of individuals to purchase private annuities can be partially attributed to their expectation that Social Security will provide enough guaranteed, inflation-adjusted income, potentially making additional, private annuities unnecessary.

[12] https://www.immediateannuities.com/annuitymuseum/historyofannuities/.

[13] 2016 GAO Report.

[14] Variable annuity net assets totaled just under $2 trillion as of 2017, according to Morningstar.

[15] Pashchenko, S. and Porapakkarm, P., 2018, Accounting for Social Security Claiming Behavior, CRR WP 2018-18, Center for Retirement Research at Boston College.

The disconnect between annuity demand and stated preferences for retirement income suggests that factors driving annuity purchases or decision-making are not entirely rational. According to Dr. Brigitte Madrian of Harvard University, several factors explain low annuity demand, such as product structures and communications around product sales.[16] Incorporating annuities into the default investment option is likely to result in higher usage than making annuities more generally available for purchase in the DC plan or via a platform, because the default option does not require an active decision.

Several witnesses highlighted the benefits of incorporating annuities within DC plans. Ted Goldman from the American Academy of Actuaries suggested that annuitization inside a DC plan allows participants to benefit from pooling longevity risk and to more easily transition from accumulation of financial assets to decumulation.[17] Mr. Pester cited Prudential research showing participants with lifetime income in their portfolios save more than the average DC participant, are more likely to maintain their strategic asset allocations even during equity market downturns, and better manage their spending patterns.

One benefit of purchasing an annuity in a DC plan is that the annuity is likely to be priced more attractively than directly purchasing an annuity in the retail market; however, most annuity purchases are unconnected to DC plans. According to an Alight Solutions' survey, just 10% of plans offered in-plan insurance products. Mark Foley of TIAA, citing the Plan Sponsor Council of America's 59th Survey of Profit Sharing and 401(k) Plans, noted that only 5% of 401(k) plans offer participants access to an in-plan annuity product. Even when offered, participant take-up rates for annuities are extremely low. Alight estimated participant usage of about 2%; Vanguard estimated usage to be 1% or less. This experience is in contrast to the 403(b) market, where, according to Professor Jonathan Forman, 84% of education and tax-exempt plans offer annuities. For one plan provider, TIAA, approximately 75% of retirees or beneficiaries take at least a portion of their benefit in the form of annuities upon retirement. In his testimony, Professor Forman summarized the historical underpinnings that led to these dynamics:

> *"I think it's a historical kind of accident…that TIAA and other companies… began offering teacher pensions… that were …basically annuity only. So, if you worked at a university…money was set aside…in what was going to be a lifetime annuity at retirement. Now… investments are just not in annuities. So… the 403(b) providers have been very comfortable offering annuities, [they] don't have … fiduciary … concerns that are so obvious in defined contribution plans…*

Despite the potential efficacy and benefits of including annuities in the default option, several witnesses noted that annuities are unlikely to be appropriate and/or necessary for all participants. First, annuities can be complicated and difficult to understand. Some annuity contracts have complex features and high fee structures. Second, interest rates have a significant impact on annuity prices, so the concurrent economic and market environments are important to determining whether an annuity is advantageous, particularly given an individuals' circumstances. In isolation, annuity premiums for males would likely be greater in a DC plan

[16] Madrian testimony.

[17] Goldman testimony.

versus in the retail market due to unisex pricing required of ERISA plans; an offset to this increase would be more attractive institutional pricing versus retail. Finally, annuities can be difficult to administer in-plan. Professor Forman, DCIIA and the American Benefits Council described several survey results that showed plan sponsors shying away from annuities in DC plans for these reasons. Diversity in retiree needs across a wide spectrum further complicates plan sponsors' situations in designing decumulation strategies and implementing payout solutions as part of a default investment.[18]

One broad assumption is that annuities are beneficial for everyone; therefore, annuities should be the default LTI solution or as a portion of an LTI solution such as within a TDF. Several witnesses noted exceptions and qualifications to this supposition that weighs into the Council's conclusions and recommendations. First, lower income workers may not realize significant economic value in having an annuity. Professor Forman opined that:

> *"[Many Americans]…simply have not saved enough in their retirement plans or otherwise to make annuitization practical."*

Jack Towarnicky of PSCA noted that some researchers assert that:

> *"[For individuals] …with modest or minimal accumulated assets the most rational annuity allocation might be zero."*[19]

Dr. Jack VanDerhei of the Employee Benefits Research Association (EBRI), presented EBRI research regarding relationships between retirement outcomes and the percentage of 401(k) savings used to purchase a deferred income annuity, relating the income to an individual's retirement readiness. Low wage workers were worse off using more than 5% of their savings to purchase deferred annuities. The next lowest wage quartile was also worse off using more than 25% of their savings to purchase deferred annuities and were about breakeven using 20% of their savings to purchase deferred annuities. On the other hand, the EBRI model showed that households with higher wages, in the third and fourth wage quartiles, experienced an increase in retirement readiness for 401(k) allocations to deferred annuities of up to 25% and 30% respectively.

Many witnesses asserted that strategies for maximizing Social Security benefits are far more effective and valuable than annuity purchases. For people with lower retirement savings balances, Dr. Teresa Ghilarducci of The New School asserted that the most optimal strategy is to self-annuitize small DC balances to bridge income between retirement and taking Social Security with the objective of delaying Social Security as long as possible. Likewise, Steve Vernon also indicated that a core principle should be to delay Social Security until age 70. Christopher Jones of Financial Engines noted:

> *"It is crucial that before any participant is defaulted into a private annuity product, that they have first maximized their claiming strategy for Social Security benefits …defaulting*

[18] Croke, Holden, Salinas, Towarnicky and VanDerhei testimony.

[19] Towarnicky testimony.

such a participant into a private annuity product may make them worse off if the default results in an inability to optimally defer the start of Social Security Benefits."[20]

Sarah Holden and Shannon Salinas of ICI asserted:

"Policymakers considering rule changes to promote annuitization within DC plans must be mindful of the impact of such changes on the resources available to households to delay Social Security claiming. If the goal is to increase annuitized income, policymakers should be promoting delayed Social Security claiming, not the purchase of market-priced annuities."[21]

- **LTI Solution Portability**

In addition to receiving testimony on LTI products, the 2018 Council explored issues with LTI product portability within the existing DC market operating infrastructure. For guaranteed products, The Institutional Retirement Income Council (IRIC) defines portability as the transferability of a participant's guaranteed LTI benefit if a plan moves between providers or a participant moves from a DC plan to an IRA product. More than 35,500 plans offer in-plan guarantee solution annuity products,[22] but these products must largely remain on the same platform where they were bought. Because current workers on average change jobs almost a dozen times[23] throughout their career, the ability to move LTI solutions is important. Upon leaving an employer, most participants currently have three options: a lump sum distribution, full or partial rollover to an IRA or qualified DC plan, or keeping money in their former employer's plan. Without portability, a participant choosing to leave an employer's DC plan could lose guaranteed benefits.

To assist with portability issues, David Ireland of SSgA recommended allowing qualified LTI solutions to be distributed from a plan without incurring tax penalties in specific cases and improving portability by evolving a DC plan from a retirement savings plan to a retirement income plan. John Croke of Vanguard stated that challenges associated with annuity contract recordkeeping and portability hinder plan sponsors' abilities to change plan design, service providers and investment options. These limitations potentially prevent plan design optimization and create rigidities and inefficiencies.

Inconsistencies across LTI products and their underlying insurance contracts not only create challenges for recordkeeping, but also limit participants in consolidating assets, increasing unnecessary costs or causing losses in unrealized benefits. Mr. Croke stated:

"For the population of participants who lack the time, willingness, or ability to make complicated investing decisions on their own, existing QDIA options are valuable innovations. The liquidity, portability, generally low costs, and broad appropriateness of

[20] Jones testimony.

[21] Holden and Salinas written testimony.

[22] See IRIC letter. LIMRA 2017 Survey.

[23] https://www.bls.gov/news.release/pdf/nlsoy.pdf.

> *target-date funds are vital features not shared by structures that include an annuity component."*

Tim Rouse of SPARK testified that in 2011, SPARK promoted portability of LTI options through standardization, culminating in guidelines for standardized LTI solution data layouts. Mr. Rouse reported that SPARK members frequently cite LTI portability as the most important issue they encounter with respect to recordkeeping LTI solutions. Mr. Rouse suggested that the Department consider developing and periodically updating flexible guidance recordkeeping data format standardization to encourage harmonization and increase portability across recordkeeping platforms. This is a topic that the Department may wish for a future Council to explore.

- **Plan Design**

  - **In-plan Versus Out-of-plan Options**

A DC plan can offer in-plan LTI features, such as an annuity distribution option or other, non-guaranteed lifetime options. To avoid fiduciary risks associated with selecting and monitoring annuity providers, plan sponsors may instead facilitate a participant's annuity purchase outside the plan through an IRA rollover.

While participants may desire flexibility in choosing among in- and out-of-plan retirement income options, multiple witnesses testified that only a small fraction of plan sponsors offer an in-plan annuity option. One witness highlighted that there has been little change in plan sponsor offerings in recent years. Mr. Towarnicky explained that PSCA survey data reflected no significant change in decumulation provisions offered over the past 10 years. Survey data revealed that in 2008, 99+% of plans offered lump sum payouts, 52% offered installment payouts, and 21% offered in-plan and or purchased annuities. A subsequent survey conducted in 2016 showed relatively small changes, with 90% of plans offering lump sums, 59% installment payouts, and 22% incorporating in-plan and/or purchased annuities.

Alison Borland from Alight similarly stated that:

> *"In 2017, only 10 percent of plans offered in-plan insurance products, such as a guaranteed minimum withdrawal benefit option, and very few plan sponsors are actively considering adding this today. Just 15 percent of plans offer an out-of-plan annuity distribution option, and that percentage hasn't changed meaningfully in over a decade."*

Many witnesses presented similar testimony corroborating the observation that many participants do not have access to in-plan annuity solutions. Witnesses cited plan sponsor fiduciary concerns as the primary reason for not offering in-plan LTI solutions. When a DC plan offers an annuity, the LTI provider selection is a fiduciary function, which imposes a duty to monitor the selected provider's and the LTI products' appropriateness. The fiduciary concerns around an in-plan solution further include requirements to ensure the annuity provider has the ability to meet contractual obligations financially. Moreover, the fiduciary must periodically review the continuing appropriateness of the conclusion that the annuity provider is financially able to make all future payments under the annuity contract, as well as the reasonableness of the cost of the contract in relation to the benefits and services to be provided.

Witnesses represented that creating in-plan annuity options is challenging due to higher fees relative to other in-plan investment options and the full LTI benefit may not be realized if the option is not portable. Additionally, LTI solutions can include various explicit charges not applicable to investment options without income guarantees, such as insurance/underwriting charges and fees for riders or a contract fee. Further, more complex products, for example GLWBs, with seemingly attractive terms (such as a low rider fee), may carry high implicit costs (such as a very low payout) and may be difficult for participants to understand. As Mr. Jones commented in his testimony to the 2018 Council:

> *"…many lifetime income products are relatively expensive, particularly vis-a-vis what you see on the asset management side in large 401(k) plans, and so there is a trade-off associated with the benefits of the product in terms of helping people mitigate longevity risk and the cost of achieving those benefits through higher fees…"*

On the other hand, some witnesses testified that the fiduciary and plan sponsor oversight are exactly the reasons that plan sponsors should provide an in-plan annuity option, rather than relying on the individual retirement annuity or account market. Dr. Tony Webb of The New School highlighted that individuals attempting to invest in IRAs are vulnerable to financial predations because the solutions offered by advisors are bound only by a suitability standard, rather than a fiduciary standard. Kelli Hueler of Hueler Companies similarly noted that plan sponsors are in a unique position in the LTI market, because unlike the providers, plan sponsors do not have conflicts-of-interest.

Mr. Goldman suggested that annuitization inside a DC plan has four important benefits:[24]

1. Participant transition from the asset accumulation to the distribution phase is easier,
2. Plan sponsor conducts provider and product due diligence review,
3. Plan sponsor, a trusted information source, gives guidance on annuitization, and
4. Plan participants can pool longevity risk.

Finally, in-plan annuities negatively affect certain participants, males in particular. In-plan annuities must be offered with sex-distinct annuity rates, whereas in the private market rates are differentiated between men and women. This requirement stems from the Supreme Court's decision in *Arizona Governing Committee v. Norris*, 463 U.S. 1073 (1983), in which the Court held that the use of sex segregated actuarial tables to calculate retirement benefits in qualified retirement plans violates Title VII of the Civil Rights Act of 1964, regardless of whether the tables reflect an accurate prediction of the longevity of women as a class. The uniform rate requirement disadvantages males, who could potentially receive a higher payout if gender-specific pricing is available, e.g., in an IRA. The impact of using gender-neutral pricing varies significantly depending on product attributes.

[24] Goldman testimony.

Beyond fiduciary concerns, Dr. Holden of ICI cited an annual Deloitte survey[25] to illustrate other reasons plan sponsors do not offer in-plan annuity options, including: administrative complexity, a lack of participant demand, lack of portability and communication challenges. Ms. Borland similarly cited fiduciary concerns, operational or administrative concerns, concerns about participant utilization, and the desire to see what evolves in the marketplace as barriers to in-plan LTI solutions.

Mr. Towarnicky testified that:

> *"Many plan sponsors favor retirement income distribution processes other than annuities because they are much less complicated and expensive to implement and maintain – yet they offer value to a much larger group of participants. Decisions to add in-plan retirement income features are typically not top priorities given diverse participant desires and the more than adequate, easily customized, decumulation/retirement income products/options in the IRA marketplace …."*

One reason suggested for using out-of-plan solutions is that workers can consolidate their retirement assets before deciding whether to use an LTI option. Because many employees have several different employers with different DC plans, the 2018 Council heard that workers might be better served by combining these investments at retirement into single accounts within which LTI decisions could then be made.

Some witnesses suggested that framing LTI issues in the context of in-plan versus out-of-plan solutions is a disservice to participants. For example, Ms. Hueler stated:

> *"Our experience tells us that the phrasing 'in-plan' or 'out-of-plan' polarizes the discussion about lifetime income and feeds into the 'either-or' mentality that has stymied plan sponsor decision making …In-plan versus out-of-plan framing also encourages product manufacturers and service providers to focus on a single alternative as the 'best' option, resulting in little innovation or efforts on anything other than their proprietary product."*

Ms. Hueler suggested that the Department encourage an inclusive system robust enough to deliver more than one type of prudent solution, by recognizing the importance of guaranteed and non-guaranteed LTI alternatives, in and out of the plan.

- **Settlor Versus Fiduciary Activity**

The Department's longstanding view is that plan sponsor decisions to offer LTI options or distribution choices to retirees is a plan design matter. These decisions are described as a "settlor" activity in nature and do not involve ERISA's fiduciary responsibility rules. The Department also has consistently taken the position that implementing plan design provisions is subject to fiduciary responsibility requirements and must be undertaken "…prudently and solely in the interest of the plan's participants and beneficiaries…" as required by ERISA section

[25] Deloitte 2017 Defined Contribution Benchmarking Survey. Appendix 2017 Edition.

404(a)(1). When offering an in-plan annuity, a plan administrator has a fiduciary obligation to prudently select and monitor the annuity product provider. While the 2008 Council Report reflected witness confusion over whether the decision to add LTI distributions options to a plan – as opposed to the selection of an LTI provider or product – is a fiduciary or settlor decision, the 2018 Council did not hear testimony suggesting continuing confusion.

Mr. Ireland summed up the settlor versus fiduciary distinction as follows:

> *"…if a type of distribution option (like a QLAC, as opposed to a particular insurer's QLAC) is included in a plan's terms, the design of that option is a settlor function. On the other hand, the choice by a plan fiduciary of investment options is a fiduciary act. The [Department] should clarify that, in performing that act, it is permissible to consider the need for lifetime income."*

Lynn Dudley of the American Benefits Council (ABC) testified that ABC's member survey indicated that the most common reason sponsors did not offer an LTI option within the plan was because of potential fiduciary liability. The fiduciary concerns around LTI options were well summarized in the written testimony provided by Fred Reish and Bruce Ashton of Drinker, Biddle & Reath, which stated:

> *"In our experience, the greatest impediment to the continuing inclusion of retired participants in defined contribution plans, and to the introduction of new products and services into those plans, is the fear that plan sponsors have of being sued for a fiduciary breach. That fear includes: possible increased damages where retirees continue to have money in a plan; claims of fiduciary breaches where a plan sponsor changes to another recordkeeper, resulting in a loss of guaranteed benefits; and litigation about annuities provided by insurance companies if their financial condition weakens."*

Some witnesses suggested that there is a role for the Department to provide further clarification in the area of fiduciary versus settlor activities. Mr. Ireland recommended:

> *"… that the [Department] issue guidance reaffirming that a plan sponsor's decision to offer guaranteed lifetime income including a QLAC as a distribution option or a default within the plan would be considered a settlor function as long as the lifetime income option is provided for within the plan."*

On the other hand, AARP's written testimony stated that the fiduciary must separately evaluate any product that includes investment and annuity elements, stating:

> *"[T]he fiduciary must ensure that both elements are prudent – not just the en toto product, but each major component – the investment and the annuity components."*

With respect to ERISA fiduciary concerns, the 2008 Council's Report reflected that:

> *"Many witnesses testified that the annuity provider selection rules create a higher fiduciary hurdle for sponsors interested in adding annuity-type investments to their defined contribution plans."*

Mr. Vernon suggested that the Department could reduce the fiduciary hurdle using a precedent similar to that established under ERISA section 404(c), under which plan sponsors may be relieved from fiduciary liability as a result of a participant selecting their individual investments. Under Mr. Vernon's suggestion, the Department would create a fiduciary safe harbor under which plan sponsors would offer participants at least three distinct retirement income solutions:

1. Installment payments with investment assets, where the goal is payments that will last for life but where there is no guarantee,
2. A lifetime annuity from an insurance company, and
3. A period certain payout that would help the participant maximize Social Security by permitting a Social Security bridge payment. Although there would still be fiduciary liability for selecting the options, the fiduciary would not be responsible for the participant's selection of any particular option.

– **Partial Annuitization**

The 2018 Council heard testimony about plan design features that allow retirees to use a portion of their accumulated assets to purchase an annuity, referred to as partial annuitization.

Participants may prefer partial annuitization for many reasons. An EBRI Issue Brief from 2017 indicated that participants have a clear preference for annuitizing smaller amounts of their accumulated assets through partial annuitization. EBRI's surveys show that only 16.5% of retirees preferred full annuitization compared to 43.0% preferring to annuitize a quarter of their assets.

The EBRI data also showed preference for annuities declines as retirees age. Dr. VanDerhei suggested that the reasons for the drop in preference for annuities as retirees age may be (1) as people age and their mortality risk increases, annuities become less attractive as more people might think they will not live long enough for an annuity purchase to be profitable, and (2) as people age and their retirement savings shrink, liquidity concerns relating to health, long-term care, and other significant expenses may also inhibit more people from purchasing annuities. Both concerns may underpin participants' desires to use only a portion of their account balances toward an annuity purchase.

Tax laws and regulations have a significant impact on partial annuitization and incentives for annuitizing. These laws and regulations fall under the Department of Treasury (the Treasury) not the Department of Labor, so the 2018 Council has limited scope for making recommendations on LTI strategies with regard to tax legislation and regulation. Under existing tax law and regulations, required minimum distribution (RMD) rules require that after a retiree reaches age 70.5, minimum distributions must be made from the retiree's qualified retirement plan benefits and IRAs. The RMD requirements also apply to Roth 401(k) accounts, although they do not apply to Roth IRA accounts while the owner is alive. These required minimum distributions

increase with age and the distributions are includable in taxable income unless an exception applies, such as a distribution of Roth 401(k) amounts.

Some witnesses argued that RMDs resulted in participants withdrawing too little of their savings during their lifetimes. Other witnesses testified that the existing RMD requirements are a viable way for a participant to receive an LTI stream while maintaining access to a liquid account balance.

Even if plans do not permit participants to partially annuitize plan balances, plan sponsors can facilitate gradual decumulation by allowing participants to take installment payments, systematic withdrawals and or managed payouts. Unlike annuities, these distribution options may be designed to last for a specified period – including up to the participant's life expectancy – but the payment stream is not guaranteed. As the benefit is not guaranteed, these options are not the same as providing longevity insurance or guaranteed asset preservation, but this solution does provide the retiree with distribution alternatives that allow for enhanced planning as compared with a lump-sum distribution. In addition, several witnesses noted advantages of partial withdrawal options, for example, to partially annuitize balances[26] or provide bridge payments to delay social security claiming.[27] According to witnesses, these features are readily available on most recordkeeping platforms at modest cost.

– **Other Plan Design Approaches**

The 2018 Council heard from witnesses representing plan sponsors, recordkeepers, insurance companies and industry associations regarding the considerable innovations in the LTI marketplace. While many ideas presented are available in plans and from providers today, other ideas were presented as theoretical constructs that plan sponsors might consider in developing LTI opportunities as part of their plans. While product developments have occurred over the past ten years, the same plan design issues and barriers noted to the 2008 Council were largely reiterated in witnesses' 2018 testimony.

Mr. Ireland presented a useful construct for considering plan design solutions from a plan participant's perspective, classifying the various options into four groups*:*

> *"(1) Do-it-for-me annuity-based options; (2) Do-it-for-me non-annuity-based options; (3) Do-it-myself annuity-based options; and (4) Do-it-myself non-annuity-based options."*

Do-it-for-me options with annuities make the participants' annuity or drawdown rate decisions for them, reducing participant decision risks. Current market offerings include TDFs with embedded annuity components. These offerings incorporate an annuity protection against longevity risk, but may also introduce fiduciary responsibilities for provider selection and monitoring. Additionally, participants may be defaulted into a product from which some of them are unlikely to benefit. Do-it-for-me non-annuity options include TDFs that do not introduce this fiduciary risk but lack longevity protection or guaranteed income of annuity-based solutions. Do-

[26] Hueler testimony.

[27] Iwry testimony.

it-myself options are standalone products or options where participants can design a decumulation strategy in accordance with their unique circumstances.

Some plan design alternatives suggested to the 2018 Council were theoretical. Whether plan sponsors have adopted these designs is not clear. For example, Mark Iwry described an option referred to as "BifuKation", under which employer contributions – whether non-elective or matching – are kept as a separate deferred annuity accumulation contribution. The sponsor distributes these contributions to the participant as an annuity. Mr. Iwry noted that this benefit form would not offer plan sponsors protection under Section 404(c) of ERISA, but would prevent the participant from taking those employer contribution amounts as a lump sum.

Mr. Iwry also described a 'trial annuity' distribution option, under which at retirement a participant receives installment payments that mimic an annuity. If the participant did not drop out of the program within a specified period, such as 24 months, the remaining balance would be converted into an annuity payment.

Finally, Ms. Borland and Mr. Rouse testified that recordkeepers can develop solutions to support new plan designs, but recordkeepers need to service these designs at scale to make the service models financially viable. As Ms. Borland stated:

> *"When it comes to complexity of record keeping, we can build anything, and if we have scale, we will build anything.... [I]t's not a question of can it be built; it's a question of is there sufficient scale for a recordkeeper to make that decision, to say yes, we're going to build it, we'll make the investment because we think we'll get a lot of business from it or we'll have a lot of clients signing up."*

D. Plan Sponsor and Participant Communications

Virtually all witnesses before the 2018 Council testified that there is no one-size-fits-all solution for LTI. Which solution is right for a particular worker depends on a variety of circumstances, including account balances, other retirement savings, the availability of a defined benefit pension, the timing and amount of Social Security benefits, household wealth, health status and healthcare costs, marital status, etc. David Certner of AARP pointed out, citing results from the 2018 EBRI Retirement Confidence Survey, that workers and retirees struggle with spending decisions in retirement.[28] Many witnesses suggested communications and guidance to help workers navigate this decision process.

One common recommendation was for plan sponsors to include income estimates in addition to account balances in quarterly plan statements. Many sponsors include this information already. For example, Eileen Leahy of Siemens Capital testified that Siemens already includes income estimates. Other witnesses worried that plan sponsors need more guidance regarding underlying assumptions and accompanying disclaimers for such estimates. Still other witnesses noted there

[28] For example, 47% of workers and 33% of retirees surveyed were not confident they will have enough money to last their entire life; and 51% are not sure how much income they will need each month.

are a number of retirement income calculators available from outside sources, including the Department's own LTI calculator available at https://www.askebsa.dol.gov/lia/home. Witnesses encouraged the Department to change messaging around DC plans, i.e., from savings vehicles to LTI generators. They also recommended that the Department create or revise educational materials specifically addressing decumulation issues.

Several witnesses suggested that the Department educate plan sponsors about plan features that they can adopt under existing law and guidance to facilitate income generation from plans as described above. The 2018 Council recommends that the Department issue guidance confirming that offering these forms of distribution is a non-fiduciary settlor act that could have a material impact on retirement income.

Finally, several witnesses, including Borland, Holden, Dudley, Hueler, Iwry and Reish, suggested that the Department revisit Interpretive Bulletin (IB) 96-1, which deals with the difference between investment education and investment advice with respect to retirement plans. The witnesses noted that IB 96-1 focuses on the accumulation phase of retirement planning and should be updated to address decumulation issues as well. The 2018 Council notes that prior Advisory Councils have addressed this issue in the context of promoting LTI. The 2008 Council recommended updating, expanding and amending Interpretative Bulletin 96-1 by adapting the bulletin to the spend-down phase.

The 2012 Council recommended that the Department "…review, modify, and or develop regulatory guidance/clarification with respect to decumulation of retirement assets, including a DC plan annuity safe harbor, participant education, and investment advice." The 2014 Council heard testimony regarding IB 96-1 but made no recommendation with respect to it.

Prior Councils have dealt extensively with this issue; therefore the 2018 Council makes no recommendation with respect to IB 96-1.

Witnesses speaking to the 2018 Council expressed concern that the Department's efforts to encourage LTI alternatives should not result in additional communication mandates upon plan sponsors. Mr. Towarnicky stated:

> *"The [PSCA] opposes new employer mandates – such as expansions in the already cumbersome number and variety of mandated disclosures. … Because of demographic, economic, financial, product, and employment trends, [lifetime income] projections are more likely to mislead than to inform…. [T]here is no documented, substantial change in participant behavior following addition of burdensome disclosure regulations."*

Mr. Jones similarly stated that:

> *"Sponsors do not want to undertake complex and costly changes to their plan, communications infrastructure, or recordkeeping systems to support retirement income."*

ERISA section 404(c) provides plan sponsors with a "safe harbor" from liability for losses that participants may suffer in their 401(k) accounts to the extent that the participant exercises control over the assets in his or her 401(k) account. To the extent that a plan sponsor intends for a participant's selection of plan investments to be governed under ERISA section 404(c), the plan

must, among other requirements, provide the participant with "the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan," including a description of the investment alternatives available and the risk and return objectives of each alternative, as well as information about transaction fees and expenses. These requirements similarly apply to LTI products offered to the participant as part of the plan. Ms. Hueler, for example, testified that the Department will need to provide guidance on how a plan sponsor may communicate to participants about how incorporating LTI alternatives is necessary to help participants manage the key risks of market volatility and longevity.

The 2018 Council also heard testimony from witnesses that to the extent a plan provides for a default LTI payout, such as a QLAC, the participant must be provided with a standard notification regarding the purchase of the product. For example, participants would need to be advised what a QLAC is, the date it would be purchased, how participants can opt out, the risks and benefits associated with the purchase, and the cost of the product.

The 2018 Council concurs with past Councils and witness testimony that plan participants, as the ultimate DC plan consumers, should be fully informed on decumulation features and strategies, and that plan sponsors would be more inclined to provide such decumulation-related information if they could rely on similar safe harbor protections, as afforded in IB 96-1 with respect to accumulation phase education. The 2018 Council also agrees with witnesses that such educational efforts should be encouraged, rather than mandated.

E. Regulatory Environment

In considering regulation-related recommendations to the Department, the 2018 Council heard testimony regarding current rules and regulations related to LTI products in the context of QDIAs, annuities and safe harbors.

- **QDIA Safe Harbor / PPA**

When a plan complies with section 404(c) of ERISA, plan fiduciaries are responsible for prudently selecting and monitoring the plan's designated investment alternatives, but they are not liable for losses resulting from a participant's selection of a particular designated alternative. Prior to the PPA, an investment for a participant who had an opportunity to direct the investment of his or her account but failed to do so, i.e., a default investment, was not eligible for section 404(c) relief.[29] In the PPA, Congress directed the Secretary of Labor to issue regulations treating a default investment in a QDIA as eligible for section 404(c) relief, thereby alleviating plan fiduciaries' liability concerns and encouraging the use of investment defaults. The regulations generally provide that relief is only available if the participant has a reasonable opportunity to make an affirmative investment election and the plan complies with certain notice, transferability and other requirements.[30] The QDIA regulations prescribe three investment alternative categories that qualify as QDIAs – a TDF, balanced fund or managed account. Other investment alternatives, such as capital preservation funds, are not eligible to be QDIAs.

[29] PPA section 624, Pub. Law 109-280.

[30] 29 CFR 2550.404c-5.

The Department's regulations technically create a safe harbor that is a nonexclusive method of satisfying a plan fiduciary's responsibility with respect to default investments.[31] A plan fiduciary may satisfy fiduciary default investment responsibilities without relying on the QDIA regulations. Hadley, Foley and Reish testified that in practice, plan sponsors are generally not comfortable going outside the safe harbor to offer a "nonqualified" default investment alternative, even if such an alternative may be prudent.

The QDIA regulations only address annuities narrowly, stipulating that an investment that otherwise meets the regulations' requirements will not fail to be a QDIA "…solely because the product or portfolio is offered through variable annuity or similar contracts or through common or collective trust funds or pooled investment funds and without regard to whether such contracts or funds provide annuity purchase rights, investment guarantees, death benefit guarantees or other features ancillary to the investment."[32] Thus, the regulations are silent on using annuities other than to indicate that offering a QDIA through a variable annuity or similar contract is permissible and that ancillary features that are common to variable annuities, such as a return of premium death benefit, will not taint the QDIA.[33] The regulations do not, however, address using annuities as investment components within a default fund or whether a qualified default fund may have distribution features.

Notably, the QDIA regulations include two transferability requirements relevant to LTI options. First, the QDIA regulations require that, within the first 90-day period after a participant is defaulted into a fund, the participant:

> *"…shall not be subject to any restrictions, fees or expenses (including surrender charges, liquidation or exchange fees, redemption fees and similar expenses charged in connection with the liquidation of, or transfer from, the investment)."*

Second, the regulations require that a participant must be allowed to transfer assets held in the QDIA:

> *"…to any other investment alternative available under the plan with a frequency consistent with that afforded to a participant or beneficiary who elected to invest in the qualified default investment alternative, but not less frequently than once within any three-month period."*

The 2018 Council heard testimony indicating that these transferability and liquidity restrictions have introduced confusion about LTI features that may not have cash values, such as living

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[31] 72 Fed. Reg. 60452, 60453 (October 24, 2007).

[32] 29 CFR 2550.404c-5(e)(4)(vi).

[33] See also Preamble to Final Regulation, 72 Fed. Reg. 60452, 60453 (October 24, 2007) (*"the Department intends that the definition of "qualified default investment alternative" be construed to include products and portfolios offered through variable annuity and similar contracts . . . where the qualified default investment alternative satisfied all of the conditions of the regulations").*

benefits. The 2018 Council also heard testimony these requirements prohibit using annuities with transfer restrictions, at least to the extent that a plan wants to fall within the section 404(c) safe harbor. In his testimony, Mr. Reish observed:

> *"The primary guidance that I've relied on in advising my clients is the conversation in the preamble to the final QDIA regulation where it basically says, you are allowed to include insurance elements in a QDIA...there have been some information letters and other pieces of guidance…But, the problem is that that is not the popular perception. And we will provide like information that an insurance company could give to a plan sponsor, the plan sponsor will send it to their attorney and they'll say, well gee that language in the preamble is not that clear, it is not primary authority. So, what I am asking for is clarification, just affirmative statements on some level of guidance that for all three forms of QDIAs, managed accounts, targeted funds and balanced funds, that they can include an insurance element and still be a QDIA. In the particular cases I have been involved in, it's been about guaranteed minimum withdrawal benefits, sort of the wrap on the investment."*

- **Annuities as QDIA Component Investments**

Witnesses noted that introducing defaults within the DC environment has worked to use the power of inertia to provide participants with better expected outcomes in the accumulation phase. In the preamble to the final QDIA rule, the Department addressed concerns that its approach to defining QDIAs takes into account only then-existing products in the marketplace and could stifle creativity in developing next generation retirement products as follows:

> *"While the Department does provide examples of products, portfolios and services…set forth in the regulation, these examples are provided solely for the purpose of providing the benefits community with guidance as to what might be included within the defined categories and are not intended in any way to limit the application of the definitions to such vehicles. The Department believes that, on the basis of the information it has at this time and the comments on the proposals generally, the approach it is taking to defining QDIAs for purposes of the regulation is sufficiently flexible to accommodate future innovation and developments in retirement products."*[34]

Mark Fortier of NISA noted that the retirement plan industry, in designing default options, has historically focused on the accumulation phase. He highlighted the movement toward and benefits of now focusing efforts on the decumulation phase:

> *"While the behavioral trappings of inertia, procrastination, and anchoring biases have informed our views and practices in structuring default investing during the accumulation years, we, as a whole have only begun to consider the cognitive and behavioral demands placed on retirees when faced with the multiple challenges of decumulation. These challenges have real life impacts on the quality of life of retirees –*

[34] 72 Fed. Reg. Number 205 Page 60452 (October 24, 2007).

> *such as under-savings for retirement from the illusion of wealth or underspending in retirement from fear of poverty."*

Several witnesses supported the inclusion of annuities in the QDIA so that during the decumulation phase, retirees' monthly Social Security income might be supplemented by income from an annuity from a DC plan. Mr. Finke testified:

> *"Despite the complexity of QDIA annuities, I have no doubt that incorporating guaranteed income into the QDIA is needed to more effectively transition defined contributions into defined spending in retirement."*

Mr. Foley further noted:

> *"While we believe the current QDIA safe harbor represents excellent progress in ensuring retirement plan participants are defaulted into diversified and well-managed portfolios like target date funds, the overwhelming majority of these default products have one significant shortcoming – the absence of guaranteed annuities within the investment."*

In this regard, the Department has attempted to facilitate new QDIA development, including those that incorporate LTI products. For example, Kevin Hanney from United Technologies Corporation (UTC) addressed in detail UTC's "Lifetime Income Strategy," a TDF offered to employees that includes a GMWB. Nearly 75% of UTC participants have been defaulted into this TDF and 80% of those defaulted have retained this option. Mr. Hanney observed that the UTC default facilitates employees' accumulation of assets to support a timely retirement, and the annuity feature supports retirees throughout their retirement years. The plan as a whole benefits from institutional pricing due to the retention of the participants' assets beyond termination.[35]

In 2014, the Department reacted to the Internal Revenue Service (IRS) Notice 2014-66 ("the Notice") on annuities in QDIAs. The Notice addressed whether a plan that included TDFs that have deferred annuities would run afoul of the tax-qualification requirements. The specific question was around whether prohibitions on discriminatory benefits, rights and features would apply if TDFs with deferred annuities were made available only to older participants. In connection with the Notice, the Treasury Department asked the Department whether TDFs with deferred annuity investments could qualify as QDIAs. In a letter written by EBSA Assistant Secretary Phyllis C. Borzi, the Department stated that:

> *"[T]he 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 the QDIA regulations. It is also the Department's view that the distribution of annuity certificates as each Fund dissolves on its target date is consistent with . . . the QDIA regulations."*[36]

[35] Hanney testimony.

[36] Letter to J. Mark Iwry, dated October 23, 2014.

Mr. Iwry, who as Senior Advisor to the Treasury Secretary and Deputy Assistant Secretary for Retirement and Health Policy was the letter's recipient, testified that incorporating the letter's conclusion in the QDIA regulations would clarify the Department's view. Mr. Iwry shared the view that the letter's informal status is hindering plan fiduciaries. Similarly, Mr. Hadley expressed the view that the final QDIA regulations address LTI by allowing that including annuity-like features does not cause an investment option to be disqualified as a QDIA. Mr. Hadley recommended that the regulations be amended to more directly address annuity features. In particular, Mr. Hadley recommended that the regulation be amended to clarify that an investment can qualify as a QDIA even if a percentage of the investment is allocated to an annuity, guaranteed income benefit, or similar feature.

Mr. Hadley further argued that the Department should provide additional guidance on whether a TDF with an annuity component could be restricted to participants or beneficiaries who had attained a specified age. He noted that LTI features in a default may not be appropriate for all participants who are defaulted into a QDIA, and that it may be appropriate for a plan to offer different default funds to different participant cohorts. While the IRS provided guidance on testing such a restriction for compliance with the qualified plan rule prohibiting discrimination in favor of highly compensated employees, he indicated that questions remain with regard to whether such a restriction is consistent with a plan fiduciary's duty of prudence and duty of loyalty.

The 2018 Council's recommendations around QDIA regulations were developed in light of these witnesses' apparent uncertainties.

- **Transferability and Liquidity Restrictions**

In 2016, the Department addressed how to treat TDFs with fixed annuity contracts that have liquidity and transferability restrictions. In an information letter addressed to TIAA, the Department affirmed that transferability restrictions on annuity contracts included in a TDF would cause the TDF to fail to be a QDIA. But the Department indicated that a reasonable plan fiduciary could prudently select as a default fund an investment with LTI elements, if the investment complies with all the QDIA regulation requirements except reasonable liquidity and transferability restrictions beyond those features permitted under the QDIA regulations. The Department concluded that such a product would not fall within the QDIA safe harbor, but may nonetheless be a prudent investment.

Several witnesses identified the transferability restrictions as a major barrier to more widespread adoption of QDIAs with LTI features. As mentioned above, Mr. Hadley and Mr. Foley both shared that, as a practical matter, plan sponsors are reluctant to utilize a default investment that does not fall within the QDIA safe harbor. Partly for this reason, plan sponsors have not widely adopted non-QDIA default investment funds.

Some witnesses shared that reasonable liquidity and transferability restrictions should be permitted under the QDIA regulations. These witnesses noted that risk pooling associated with annuities is undermined if participants have the option to liquidate their investment at any time. Mr. Foley argued that:

> *"[G]uaranteed illiquid annuities are entirely appropriate investments and should be incorporated into the mix of asset classes that make up QDIAs. Given the long-term time horizon of retirement investors, a higher yielding yet less liquid fixed annuity can be more effective in delivering better outcomes during the savings years and throughout retirement."*

Mr. Ireland pointed out that the transferability requirements entirely foreclose use of QLACs as elements of a QDIA, since QLACs by definition may not be liquid or transferable. Elizabeth MacGowan, speaking on behalf of the Indexed Annuity Leadership Council, shared that annuities with cash-out features commonly impose surrender charges to address adverse selection issues and that surrender charges or liquidity restrictions are necessary to ensure annuity market continuity and operations. She posited an effective equivalency between transferability restrictions and surrender charges, indicating that both allow an insurer to credit a higher long-term rate of return:

> *"It is important to remember that surrender charges allow an insurance company to maximize amounts that can be credited to a policy by permitting longer term investments to support the interest credit."*

Mr. Hadley similarly pointed out that QDIA regulations do not acknowledge this relationship between surrender charges and transferability. He pointed out that after the first 90-day period in which surrender charges may not be imposed, a QDIA may impose a surrender charge but may not impose a liquidity restriction that serves the same function. Thus, a QDIA that imposed a surrender charge could be qualifying, while one that simply imposed a liquidity restriction would not be qualifying.

These two commenters indicated that the 90-day restriction was not as problematic as the ongoing requirement to allow transfers out of a QDIA. In this regard, they indicated that the insurance industry is familiar with so-called "free look" requirements. While these requirements are generally applicable for relatively short time periods, they opined that the industry could reasonably adapt to a 90-day free look period.

Dr. Webb of The New School noted, however, that if the current QDIA regulations' liquidity restriction was loosened, participants and beneficiaries would require strong rules to protect them, noting that such loosening could tie individuals to potentially high fee, high risk investments. Mr. Croke and Ms. Salinas argued that the existing transferability and liquidity restrictions are essential to the notion of a default investment, with Ms. Salinas stating that:

> *"Eliminating or relaxing the requirement that participants and beneficiaries be able to move their assets out of the QDIA generally once in every 90-day period, specifically to promote annuities, could harm participants…The ongoing ability to move assets…..is important because the individual may not fully appreciate the implications of the default investment until later; the individual's circumstances could change such that the product is no longer suitable; or the annuity provider itself could experience problems impacting its ability to make all future payments under the contract."*

As the witness testimony highlighted, using fixed annuity contracts as components of default funds potentially conflicts with QDIA regulations' liquidity and transferability requirements. Annuity contract pricing depends on a pooling mortality risk. The extent to which a participant can receive the actuarial present value of his or her contract upon becoming ill or approaching death fundamentally undermines mortality risk pooling. Apart from mortality risk, as the 2018 Council learned from Mr. Foley, an insurer's ability to credit a higher rate of return on a deferred fixed annuity contract depends on the insurer's ability to hedge its obligations with a longer duration fixed income securities portfolio. Payment acceleration can undermine the portfolio and lead to reduced rates of return for participants. Essentially, liquidity and transferability come with increased costs and may limit attractiveness of annuities in QDIAs; however, defaulting participants into an investment into which they will be locked may also be inappropriate.

Underlying the QDIA regulations is the notion that participants with a meaningful opportunity to opt out of a default investment have effectively made an affirmative election for the QDIA. In practice, many participants are likely invested in QDIAs with little awareness and without consent. In such a circumstance, the ability to opt out after the default investment is critical and a short window, such as the 90-day window contemplated in the QDIA regulations for certain fees, does not adequately address this issue.

Differences within participant populations, such as different health risks, access to income and liquidity needs exacerbate these concerns and make locking a participant into a fixed annuity contract potentially inappropriate. Consider, for example, a participant who is suffering from a life-threatening illness and is defaulted into a life annuity contract without a cash refund provision, so he or she cannot liquidate. This situation could result in the participant losing their retirement savings and their heirs' inheritance as a result. Similarly, the 2018 Council heard repeated testimony that many participants, particularly low balance participants, would be better off not annuitizing their retirement savings but relying on other non-binding strategies. The 2018 Council is also cognizant that some annuity contracts are complex and not transparent. Witnesses expressed concern that participants may become locked into complicated, high priced commercial annuities.

For these reasons, notwithstanding some commentator requests to relax existing transferability and liquidity requirements to permit illiquid fixed annuities in a QDIA, the 2018 Council does not recommend such action. Rather, the Department should retain the existing transferability and liquidity requirements. These transferability and liquidity restrictions should not foreclose using fixed annuities in QDIAs; rather, they provide important participant protections, as reflected in Mr. Hanney's testimony and Phyllis Borzi's letter to Mark Iwry; liquid, transferable fixed annuity contracts in a QDIA are available in the marketplace. Further, while the 2018 Council recognizes that plan sponsors prefer QDIA safe harbor regulations, the mere fact that a default fund does not fall within the safe harbor does not mean the default fund is imprudent.

As Mr. Hadley and Mr. Foley pointed out, allowing surrender charges in lieu of liquidity restrictions, as the current QDIA regulations permit, is difficult to reconcile with the policy reasons for having those restrictions. Under the current rules, an insurer can impose a surrender charge on transfers to protect risk pooling and interest rate hedging. Consequently, an LTI product could arguably satisfy the QDIA regulations while imposing a significant penalty that

deters participants from opting out of the QDIA. Put differently, such a penalty could mean that the liquidity and transferability requirements are satisfied in name only. The 2018 Council recommends that the Department amend the QDIA regulations to address the extent to which surrender charges may be imposed and ensure the charges are not an indirect way of limiting liquidity.

In addition to testimony around changing transferability and liquidity requirements, the 2018 Council heard testimony about how QDIA transferability and liquidity requirements apply to living benefits. Mr. Reish testified that while some ERISA experts doubt whether living benefits can be included in a QDIA, he believes they are permissible. Notably, the 2018 Council heard testimony from one large plan sponsor, Mr. Hanney of United Technologies, utilizing a default fund with a GMWB.

Living benefits raise issues because these benefits do not ordinarily have a market or calculated value. For example, if a participant divests from a default fund with a GLWB, the participant will receive cash for market value of the investments but no compensation for the GLWB's value. Additionally, the withdrawal benefit lapses. The 2018 Council heard testimony that living benefit costs can be significant, e.g., approximately 100 basis points annually for institutionally priced benefits.[37] Dr. Webb and Mr. Goldman questioned whether participants opting out of the default were receiving fair corresponding benefits although one can argue that participants receive a corresponding economic benefit by virtue of the coverage provided by the living benefit. Given the lack of clarity, challenging policy considerations, and the issue's importance, the 2018 Council recommends that the Department issue guidance addressing how the transferability and liquidity requirements of the QDIA regulations apply to living benefits.

More generally, the 2018 Council heard extensive testimony reflecting the challenges associated with using a single default fund with annuity components for all of the participants in a plan. Many of the witnesses noted the difficulties associated with applying a homogeneous default investment to a heterogeneous participant population. And some witnesses, such as Mr. Hadley, indicated that it is appropriate for a single plan to utilize more than one QDIA, such as QDIAs with and without lifetime income features, in order to address the heterogeneity issue. In this respect, both the Department of Labor and the Internal Revenue Service effectively endorsed this approach, subject to certain design considerations, in Notice 2014-66, which explicitly addressed a plan with two different QDIAs that are available to different plan cohorts. The 2018 Council agrees with this view and believes that it is entirely appropriate for plan fiduciaries to consider different default investment options for different demographics within a single plan.

The 2018 Council further notes that qualified default funds without LTI have similar challenges in ensuring that the default is appropriate for the plan's participant population.[38] The existing QDIA regulations address this issue in the context of balanced funds, which are a permitted type of QDIA, by requiring that the plan fiduciary determine that the balanced fund has "a mix of equity and fixed income exposures consistent with a target level of risk appropriate for

[37] Hanney Testimony.

[38] A TDF may be viewed as multiple defaults because a TDF is typically a series of different funds each with different target dates, or vintages.

participants of the plan as a whole."[39] Even outside of balanced funds, the Department has encouraged plan fiduciaries to take into account participant characteristics in selecting TDFs, even though the Department has not explicitly made such a determination a requirement in the QDIA regulations.[40] Problems of diverse population needs and defaults are more pronounced and more significant for lifetime income given the many factors that influence whether an LTI default is appropriate for a particular participant. In this regard, the 2018 Council believes that plan fiduciaries should consider whether a QDIA with LTI features is appropriate for impacted participants as a whole and, if the population is too diverse, should consider multiple default funds. For this reason, the 2018 Council recommends that the Department amend the QDIA regulations to address using LTI in a QDIA. Such changes should require a plan fiduciary selecting a QDIA with an LTI option to determine whether the default is appropriate for participants as a whole, similar to rules applicable to QDIA balanced funds, considering the participant population characteristics. This guidance should confirm that multiple QDIAs may be used, which should alleviate concerns about the use of multiple QDIAs raised by witnesses.

- **The Annuity Safe Harbor**

Selecting an annuity provider for a DC plan is subject to the fiduciary prudence standard of Section 404 of ERISA. As noted above, several witnesses testified that fiduciary liability concerns are one significant reason more plan sponsors do not offer annuity-based LTI solutions. The Department has adopted a fiduciary safe harbor regulation under ERISA that provides a framework for selecting annuity providers in DC plans, set forth in Regulation Section 2550.404a-4.[41] Procedurally, fiduciaries must engage in an objective, thorough and analytic

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[39] 29 CFR 2550.404(c)(5)-5(e)(4)(ii).

[40] Target Date Retirement Funds: Tips for ERISA Plan Fiduciaries (February 2013) ("You should consider how well the TDF's characteristics align with eligible employees' ages and likely retirement dates. It also may be helpful for plan fiduciaries to discuss with their prospective TDF providers the possible significance of other characteristics of the participant population, such as participation in a traditional defined benefit pension plan offered by the employer, salary levels, turnover rates, contribution rates and withdrawal patterns.").

[41] 29 CFR §2550.404a-4 provides in relevant part:
Selection of annuity providers – safe harbor for individual account plans.
(a) Scope.

(1) This section establishes a safe harbor for satisfying the fiduciary duties under section 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1104-11, in selecting an annuity provider and contract for benefit distributions from an individual account plan.

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(b) Safe harbor. The selection of an annuity provider for benefit distributions from an individual account plan satisfies the requirements of section 404(a)(1)(B) of ERISA 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 the provisions of this paragraph (b).

search, must consult with experts where necessary and must consider appropriate information. Substantively, fiduciaries also must "appropriately conclude" that the provider can financially make all future payments under the annuity contract and the annuity cost is reasonable relative to the benefits and services to be provided. To address concerns about the safe harbor that might dissuade plan sponsors from offering annuities, the Department issued Field Assistance Bulletin (FAB) 2015-02. Among other issues addressed in the FAB, the Department highlighted that under the annuity selection safe harbor, a fiduciary must appropriately conclude that, at the *time of the selection* [emphasis added by the Department], the annuity provider can financially make all future payments under the annuity contract. The FAB assures fiduciaries that selecting and monitoring an annuity provider will be judged based on information available at selection and each periodic review — and not with reference to subsequent events or hindsight.

Fiduciary concerns have not been fully allayed despite the FAB. Several witnesses recommended that the Department consider changes to the annuity selection safe harbor. In particular, witnesses expressed uncertainty around judging whether a fiduciary's process for evaluating financial strength was appropriate and sufficiently detailed to assess a provider's long-term solvency. Mr. Pester suggested that such a change should be made in line with GAO recommendations that the Department clarify the safe harbor. With the limited exception discussed below, no witnesses offered concrete suggestions as to what revised safe harbor requirements should be.[42]

A few witnesses, including Mr. Pester and Mr. Foley, favored allowing fiduciaries to rely as a safe harbor on representations that an insurer is licensed by a state to offer guaranteed retirement income products and has met certain state insurance regulatory requirements. The 2018 Council notes that proposed legislation contains this approach – The Retirement Enhancement and Savings Act of 2016 (RESA), reintroduced in 2018 – as discussed below. Other witnesses expressed concerns about relying solely on state insurance regulators' certification. Mr. Reish asserted that this approach is not sufficiently protective, noting that oversight quality varies considerably by state. Other witnesses noted that reliance on state insurance guarantee funds could leave participants without adequate coverage if an insurance company defaults. Ms. Dudley of ABC and Ms. Leahy of Siemens suggested that plan sponsors would want more due diligence than simply relying on state certification.[43] Ms. Leahy noted that Siemens would not likely rely on the safe harbor elements of RESA, but rather turn the annuity selection decision over to an independent fiduciary. For smaller plans, this potentially added expense would be a deterrent to using insurance company guaranteed products in LTI options.

In sum, the 2018 Council did not receive suggestions for a new safe harbor that would meet plan sponsor concerns without hiring an independent financial expert or eliminating plan sponsor

[42] In an appendix to an earlier white paper cited in his written testimony, Mr. Reish offered at least 15 factors a prudent fiduciary might consider in selecting an in-plan annuity provider, with each factor having a number of associated benchmarks. He did not appear to suggest the detailed 5-page checklist is appropriate for a safe harbor.

[43] Further, the 2018 Council notes that in 2012, a representative of the regulators themselves – the National Association of Insurance Commissioners (NAIC) -- opined this would not be a good idea– "In response to a question from the Council, Ms. McPeak [of NAIC] noted that she did not believe it would be sufficient to establish a safe harbor based solely on the fact that a life insurance company and annuity provider is licensed in a state."

fiduciary responsibility for the selection altogether. Consequently, the 2018 Council is not recommending changes to the current safe harbor.

The Council, however, received testimony suggesting that plan sponsors' concerns about fiduciary liability could be addressed at least somewhat through guidance clarifying whether the ERISA section 3(38) construct is available for independent financial experts who are hired to select LTI solutions for distribution purposes. Under section 405 of ERISA, a plan fiduciary who engages an investment manager described in section 3(38) of ERISA is solely responsible for the prudent selection and monitoring of the investment manager but is not responsible for investment decisions made by the investment manager. In effect, the plan fiduciary delegates discretion to the investment manager and is only responsible for the delegation. Mr. Reish argued that such a structure would be helpful for plan sponsors who may not have the investment expertise necessary to select insurance providers and would rather not maintain the shared fiduciary responsibility associated with hiring an independent fiduciary expert. In particular, he noted that many insurance experts are not qualified to be 3(38) investment managers.

The Council believes that a plan fiduciary may hire a 3(38) investment manager to exercise discretion over the construction of a QDIA that includes LTI features, including annuity features. For example, a plan sponsor that wishes to construct a QDIA with fixed annuity components could engage a 3(38) investment manager to create and oversee the QDIA. In such a circumstance, the plan fiduciary would be solely responsible for the prudent selection and monitoring of the investment manager. The Department took this position implicitly in its letter to Mark Iwry that was later incorporated into IRS Notice 2014-66. At least one witness, Mr. Ireland, indicated that this guidance was not enough:

> *"The DOL should reiterate the guidance it provided in its October 2014 exchange of letters with the Treasury Department in a regulation or other more formal guidance and should state that an ERISA Section 3(38) investment manager can act as the fiduciary in the selection of the guaranteed lifetime income option (including a QLAC) provider. Despite the clarity of the Department's statements in the exchange of letters, in our interactions with plan sponsors they continue to raise concerns about their fiduciary liability even when the investment manager is making the insurer selection."*

The 2018 Council agrees with this comment and recommends the Department more formally clarify that the 3(38) construct is available for the selection of annuity contracts.

There is a related question of whether a plan fiduciary may hire a 3(38) investment manager to select annuity providers for distributions from DC plans. In this regard, the annuity selection guidance discusses the use of an independent financial expert but makes no reference to a 3(38) investment manager.[44] The 2018 Council believes it would be helpful to have greater clarity around whether a plan fiduciary may select a 3(38) investment manager for purposes of selecting annuities for distribution purposes. This approach is a logical extension of the current regime that clearly focuses on investment rather than distribution management.

[44] 29 CFR 2550.404a-4.

The 2018 Council is not proposing, as Mr. Reish suggested, to broaden the definition of a 3(38) investment manager to include persons who possess expertise in insurance but are not representatives of registered investment advisers, insurance companies or banks. The 2018 Council recognizes that many annuity experts are not eligible to be 3(38) investment managers. The 2018 Council is not certain the Department has authority to extend the statutory definition or whether such an extension would be appropriate without creating minimum necessary qualifications. In this regard, the Council did not hear sufficient testimony on the appropriate minimum qualifications. Moreover, the Council notes that even if the plan sponsor could delegate responsibility to an independent financial expert under the general delegation provisions of section 405 of ERISA, such a delegation would not satisfy plan sponsor concerns in the same way that delegation to a 3(38) manager would.

- **Proposed Legislation RESA 2016 (reintroduced in 2018)**

RESA proposes to amend the Internal Revenue Code and ERISA to include modifications to requirements for tax-favored retirement savings accounts and employer-provided retirement plans. With respect to employer-provided plans, among other changes the bill modifies requirements regarding selecting LTI providers.

RESA aims to help participants focus on LTI, as opposed to accumulated balances. Some of the bill's proposed regulatory requirements are aimed at encouraging employers to offer annuities in retirement plans. Specifically, the bill tries to change ERISA's current safe harbor provision to mitigate employer concerns about adding an annuity option to their retirement plan offerings. Another provision is aimed at improving LTI option portability, so that participants can preserve these options and avoid surrender costs.

The American Council of Life Insurers (ACLI) submitted a written statement supporting aspects of the bill that would allow employers to rely on the state insurance commissioner analysis and specific insurer representations regarding a plan's status in relation to state insurance regulation and enforcement. Employers would still be obligated to "prudently select" an annuity and an annuity provider, but the change is intended to encourage more employers to offer an annuity option to their employees.

Industry groups such as the ACLI, and consumer advocacy groups such as AARP, support RESA. According to written statements by Joyce Rogers, AARP's senior vice president for government affairs, AARP is pleased that:

> *"...RESA has been amended to make clear that the safe harbor is limited to determining the solvency of the selected insurer, and in no way changes the longstanding [federal retirement law] fiduciary requirements for prudent selection of an appropriate annuity product."*

RESA was not a focus of the 2018 Council; however, Ms. Leahy of Siemens and Ms. Dudley of the American Benefits Council indicated that even if RESA were enacted, plan fiduciaries would likely require additional due diligence above that proposed in RESA in the annuity provider selection and monitoring process.

The 2018 Council is aware that in addition to RESA, there are a number of legislative proposals (e.g., the Family Savings Act) made during 2018 that address the LTI topic.

V. APPENDICES

A. LTI Solutions

Table 1: Guaranteed Income Solutions

	Participant Engagement Required				
	Low				High
Option	**Annuity as part of plan default**	**Annuity available in-plan (but not part of default)**	**Out-of-plan platform (direct rollover)**	**Guidance on optimal Social Security retirement benefits claiming**	**No guaranteed income guidance**
Description	Some type of guaranteed income product is included as part of the plan default where the participant would automatically purchase the product (unless he/she opts out)	The plan sponsor offers an annuity in the plan that a participant can choose to allocate to	The plan sponsor gives participants direct access to an annuity purchase platform via an IRA rollover. It would be up to the participant to determine the annuity type/attributes	The plan sponsor does not provide direct access to an annuity in the plan or outside the plan, but does provide general guidance on optimal Social Security claiming strategies (e.g., via some type of software tool or general information)	No guidance on guaranteed income is provided whatsoever
Advantages	Given high default acceptance, including the annuity as part of the default would likely result in a significant percentage of participants purchasing an annuity	Each participant can decide if the annuity is appropriate for him/her. Plan sponsor likely to receive institutional pricing	More attractive pricing for males, less perceived fiduciary risk for plan sponsors, large scope of potential offerings (depends on platform)	Less perceived fiduciary risk for plan sponsors, good way for most participants to achieve more guaranteed income (versus purchasing a private annuity)	Lower perceived liability from the perspective of the plan sponsor

Participant Engagement Required Low					High
Option	**Annuity as part of plan default**	**Annuity available in-plan (but not part of default)**	**Out-of-plan platform (direct rollover)**	**Guidance on optimal Social Security retirement benefits claiming**	**No guaranteed income guidance**
Disadvantages	A "one-size-fits-all" approach where even if the annuity allocation was well calibrated to participant demographics, it may result in some participants who are unlikely to benefit from the annuity ending up owning it	Utilization is likely to be low, potentially limited scope of products offered (e.g., if only a GLWB is offered and the participant would have been best served with a DIA [deferred income annuity]), gender-neutral pricing is disadvantageous for males versus retail	Utilization tends to be low, participants would be limited to whatever is available on the platform, participants must determine the appropriate annuity allocation	Only a single solution, needs to be coordinated with overall optimal retirement strategy	Reduces the probability of participants considering guaranteed income as part of their retirement strategy, despite potential benefits for some

Table 2: Asset-only (Non-Guaranteed) Income Solutions

Participant Engagement Required					
Low					High
Option	**Default strategy designed for retirees**	**Managed Accounts/robo-solution**	**Prepackaged retirement funds (e.g., managed payout) offered not part of the default**	**Offer (non-multi-asset) funds as part of the core DC menu that are more retirement-focused**	**Traditional core menu (not retirement-focused)**
Description	Plan default investment (e.g., a target-date fund) includes some type of retirement-focused strategy	Personalized service can provide guidance on things like asset allocation, savings, spending, drawdown, etc. Typically an opt-in arrangement but could also be offered as part of the default	A multi-asset solution that provides a single investment option that could be appropriate for retirees	Provide participants with core menu funds that are more geared towards the risk faced by a retiree as well as those options that are more likely to best be used by a retiree	Traditional core menu of investments not considering the unique needs of retiree investors (likely how most DC menus are constructed today)
Advantages	Ensures that as each participant transitions into retirement, the portfolio reflects the "average" change in objectives over the lifecycle (e.g., goes from risk-seeking to liability-hedging)	Personalized fiduciary-level advice for each participant	Participants select on their own	Gives participants access to "building blocks" required to create portfolios more geared towards retirement	Simplicity
Disadvantages	"One-size-fits-all" and may not be appropriate for all participants	Higher costs associated with solution	May not be used by participants	Requires participants to build portfolios themselves	Does not help participants create an efficient strategy in retirement

B. GLOSSARY

Fixed Life Annuity: A product that pays a specified level income. The contract may include a fixed annual increase or cost-of-living adjustment (COLA)) paid for life. Either single life or joint life options are typically available. The product may include an initial minimum guarantee period so that in the event of death prior to the end of the guarantee period, income continues to be paid to the beneficiary until the end of the guarantee period.

Fixed Period Annuity: A product that pays a fixed level income paid for a defined finite time period. This contract may also include a fixed annual increase or COLA.

Guaranteed Minimum Income Benefit (GMIB): This benefit is typically a rider to a variable annuity contract that provides the policy holder with a defined lowest possible LTI amount. The amount is usually calculated per $1,000 of accumulated savings value. The minimum income amount is guaranteed to increase regardless of the performance of underlying funds.

Guaranteed Lifetime Withdrawal Benefit (GLWB): This allowance is typically a rider to a variable annuity and allows a defined amount, e.g., 5% of the balance for a 65-year-old, to be deducted from a deferred annuity account in perpetuity. This contract term means that once an account is fully liquidated, the guaranteed withdrawal amount will continue to be received as long as the contract owner lives.

Interest Only Withdrawals: This income option relies on systematic withdrawals from a savings account where the earnings are paid out as income on a periodic basis.

Living Benefits: Living benefit riders generally guarantee some sort of pre-defined minimum income level while the insured or annuitant is still alive, even if the underlying contract value goes to $0.

Longevity Insurance: This contract is a lifetime annuity that starts paying benefits at a specified future date or advanced age, e.g., not at retirement but when the policy holder is 80 or 85 years old.

Lump Sum: A one-time, single payout or withdrawal of a retirement savings account total balance. Once the lump sum payment is made, the recipient can use the funds for any purpose, but there is no further amount payable from the account.

Qualified Longevity Annuity Contract (QLAC): A deferred annuity with specific restrictive provisions.

Payout rates: The annuity income amount divided by the initial premium.

Systematic Withdrawals: Balance removals taken from a deferred annuity or a retirement fund on a methodical basis. The deductions can accommodate most desired income patterns. Once the savings balance is fully liquidated, income payments cease.

Target Date Fund: An investment fund, product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses, and is designed to produce varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age or target retirement date.

Target Income or Managed Payout Funds: Mutual funds providing an annual income based on a fixed period where income varies or a fixed percentage of original investment where the income payout period varies.

Variable Life Annuity: An insurance contract under which income is paid for life. The amount of income varies each year based on the performance of underlying investments that the contract holder selects. Single life or joint life options are available. The product may include an initial minimum guarantee period, so that in the event of death prior to the end of the guarantee period, income continues to be paid to the beneficiary until the end of the guarantee period.