

Advisory Council on Employee Welfare and Pension Benefit Plans

Report to the Honorable Hilda L. Solis,
United States Secretary of Labor

Examining Income Replacement During Retirement Years In a Defined Contribution Plan System

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2012 ERISA Advisory Council Report:

Examining Income Replacement During Retirement Years in a Defined Contribution Plan System

NOTICE

This report was produced by the Advisory Council on Employee Welfare and Pension Benefit Plans, usually referred to as the ERISA Advisory Council (the Council). The Council was established under Section 512 of ERISA to advise the Secretary of Labor. This report examines Income Replacement During Retirement Years in a Defined Contribution Plan System. The contents of this report do not represent the position of the Department of Labor (DOL).

ABSTRACT

The 2012 ERISA Advisory Council (the Council) examined income replacement during retirement years in a defined contribution retirement system and the issues individuals and plan sponsors face to ensure financial security during the participants' retirement years. In the past, the challenge of providing retired employees with a source of income to last during their retirement was primarily met through a source of lifetime income provided by employer-sponsored defined benefit pension (DB) plans. To that end, DB plans typically offered an annuitized benefit to participants. The responsibility of providing such a lifetime benefit was that of the plan sponsor through the design of the plan. However, the continued shift from DB plans to defined contribution (DC) plans as a primary source of retirement income has shifted the burden of providing a continued stream of income during the retirement years of DC plan participants. As a result of this shift there is a growing need for plan sponsors to examine, evaluate and make available to participants, options designed to address their retirement income needs in a DC plan context. In addition, there is a need to sufficiently educate participants so that they can fully understand the importance of viewing and analyzing their account balances as a source of lifetime income. The Council believes that this education will better equip participants to exercise meaningful choices with regards to their continued financial security during retirement.

The purpose of the Council's examination of this issue is to provide recommendations to the Department of Labor (DOL) on guidance for plan sponsors and participants at a time that this topic is being highlighted among pension experts, and the market is beginning to respond with innovative products. Examination of the issue focused on the following: (1) the challenges participants face in making their account balances last for the length of their retirement years, especially in light of improved longevity; (2) what options and resources should be available to participants to help them in their efforts to transform their accumulated savings into a continued flow of income designed to last over their retirement lives and/or the lives of their spouses; (3) what considerations and/or challenges plan sponsors encounter when making these options available to plan participants; and (4) what considerations and challenges face plan sponsors in

providing education outreach for participants of DC plans regarding available income replacement options.

Through testimony and research, the Council developed recommendations to the Secretary that certain plan sponsors and participants may find beneficial when examining options for income replacement in a DC plan system. Specifically, the recommendations in this report include enhancing regulatory and sub-regulatory guidance that may help plan sponsors address their fiduciary concerns when offering income replacement options or advice on available options, and the development of educational/outreach materials for both plan sponsors and participants to result in a greater chance of DC participants achieving lifetime income in retirement.

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I. EXECUTIVE SUMMARY

Traditionally, defined benefit plans (DB) offered participants a steady stream of income through their retirement years as a result of plan design and distribution options. With the continued shift from DB plans to defined contribution plans (DC) as a primary source of retirement income there is a growing need to examine options designed to respond to participants' retirement security needs, and the inherent risks of either outliving their income or not being able to maintain a certain lifestyle during retirement.

Some of the issues discussed in this report include:

- Whether a plan should focus on providing a single benefit option or multiple benefit options in an effort to adequately address the different needs of participants, including diversification;
- The factors to be considered by the plan sponsor in making income replacement options available;
- Whether there are additional fiduciary considerations raised by making various options available, and how plans sponsors/plan administrators prudently manage these issues while adequately assisting plan participants;
- What are the challenges participants face in making their account balances in DC plans last for the length of their retirement years, especially in light of improved longevity;
- What are some of the lifetime income replacement options available to participants that would help them in their efforts to make their accumulated savings last over their retirement lives and/or the lives of their spouses;
- What level of education should be provided to plan sponsors and participants to assist them in evaluating and selecting lifetime income replacement options.

The Council researched and took testimony on (1) the challenges participants face in making their account balances last throughout their retirement years, and (2) what options would be helpful in their efforts to make their accumulated savings last over their retirement lives and/or the lives of their spouses. With respect to the participants, the Council received testimony and reviewed materials involving the type of educational materials that should be made available for participants to assist them in evaluating and selecting income replacement options.

The Council also received testimony on the challenges plan sponsors encounter when offering certain income replacement options, as well as providing education regarding the spend-down options of the participant's account balances. In particular, witnesses discussed the current concerns with respect to fiduciary liability that could be triggered when providing education to participants that goes beyond the "accumulation of assets" phase. In addition, there was much discussion that focused on the standard that must be upheld by sponsors when selecting an annuity issuer as set forth in DOL Regulation section 2550.401a-4.

Witnesses that appeared before the Council include members of the Employee Benefits Security Administration (DOL), representatives from the National Association of Insurance Commissioners (NAIC), investment managers and investment advisors, and attorneys that counsel plan sponsors on the administration of pension and welfare benefit funds.

II. RECOMMENDATIONS

After examining the issue of Income Replacement During Retirement Years in a Defined Contribution Plan System, the Council developed the following recommendations. The Council recommends that:

1. DOL 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 guidance/clarification should be designed to reduce current barriers faced by fiduciaries, plan sponsors, and service providers in their efforts to encourage participants to develop post-retirement income strategies and to consider alternatives in offering income replacement options.
2. DOL develop more immediate clarification in the same areas in the form of FAQs or other sub-regulatory guidance while DOL examines the recommendation set forth above.
3. DOL develop educational materials to assist employers and plan sponsors in evaluating and selecting income replacement options. The materials should focus on aspects such as:
 - a) The need to accomplish a shift in the perception of defined contribution plans, to include the importance of the decumulation (retirement distribution) process;
 - b) Commonly applied definitions;
 - c) Features, designs, risks, and trade-offs;
 - d) Roles of a plan sponsor/employer when offering income replacement options, education, and advice;
 - e) Review and evaluation of projection tools used for income replacement stream;
 - f) Lessons from behavioral finance and research about misconceptions related to income strategies, planning horizons, and understanding of longevity risks.
4. DOL develop educational materials to assist individuals in understanding and choosing income replacement options to best suit their retirement needs, including:
 - a) The importance of understanding the life-cycle approach to planning;
 - b) Key features, designs, risks, and trade-offs;
 - c) The importance of understanding the tools and assumptions used to project income stream;
 - d) The need to evaluate all household sources of retirement income, including survivor benefits and Social Security;
 - e) The impact of inflation and inflation assumptions;
 - f) Understanding the impact of longevity and longevity risk, the need for a long planning horizon and potential benefits from mortality risk pooling;
 - g) The timing of decisions and alternatives.

Other Important Issues

- A. Auto enrollment or other default features for income replacement options which could include a safe harbor.

B. Barriers to a plan sponsor acting as a facilitator of income replacement options outside of an employer-sponsored plan.

C. Income illustrations of the participants' account balances on their benefit statements.

III. BACKGROUND

1. The Shift in Retirement Coverage and Some Resulting Consequences

Employer-sponsored pensions represent an important component of retirement income. Since the early 1980s, the percentage of workers participating in a pension plan has remained around 50 percent of the private sector work force. However, in recent years pension coverage has seen a noticeable shift away from “traditional” DB plans to DC plans. According to recent reports, in the context of private employers offering DB single-employer pension plans, the percentage has decreased to less than 9 percent, while employers offering single-employer DC pension plan increased to more than 88 percent.

In traditional DB plans, workers typically accrue benefits that are based on years of service and earnings. In DC plans, participants have an individual account within the plan and the balance is a combination of a participant's contributions, investment gains or losses, and in some cases employer-matching contributions. One of the important differences between a DB plan and a DC plan is the method of distribution of the participant's benefit – in the DB plan the option of taking the accrued benefits in the form of a lifetime annuity is often presented to the participant. In a DC plan this distribution option is generally the exception rather than the norm, with most account balances being distributed as a lump sum amount.

The continued trend toward expanding coverage under DC plans within our retirement system, and the corresponding shrinking coverage under DB plans, is producing a large percentage of workers who will be forced to rely increasingly on their DC plan accumulated account balances to provide financial security during their retirement years. As the number of employees in this situation grows, these individuals will face having to make important decisions regarding how to make their account balances last for a desired length of time, and in many cases, last throughout their retirement years. Retirement years represent a period in life that is becoming increasingly longer due to improved longevity.

Longevity is used in this context to represent the number of years that is left for someone at a given age. Life expectancy in the United States has been on the rise for a decade, and in 2007 reached a high of nearly 78 years, up from 77.8 a year earlier. Not only are people living longer, but they also are living an active lifestyle. In 2007, the average life expectancy for women was 80.4 years and 75.3 for men. The table below provides a summary of the recent life expectancy of individuals living in the United States:

Expectation of Life at Birth, 1970 to 2008, and Projections, 2010 to 2020

Years	Total	Males	Females
1970.....	70.8	67.1	74.7
1980-1982	74.5	70.8	78.1
1983-1985	74.7	71.1	78.2
1986-1988	74.9	71.4	78.3
1989-1991	75.5	72.0	78.9
1992-1994	75.7	72.4	78.0
1995-1997	76.5	73.6	79.4
1998-2000	76.8	74.1	79.3
2001-2003	77.1	74.5	79.8
2004-2006	77.7	75.1	80.2
2007-2008	78.0	75.5	80.5
Projections			
2010	78.3	75.7	80.8
2015	78.9	76.4	81.4
2020	79.5	77.1	81.9

Source: U.S. Census Bureau, Statistical Abstract of the United States: 2012

The above table can even understate the impact of increased life expectancy on retirement income considerations. As people age, the average individual who survives to age 65 can be expected to live well beyond these general life expectancies set forth above. According to data provided by the Centers for Disease Control (<http://www.cdc.gov/nchs/data/hus/2011/022.pdf>), while the average life expectancy from birth, in 2009, was 78.5, the average life expectancy for someone age 65 was 19.2 years, or age 84.2. The gap has narrowed somewhat from past years, as the absolute life expectancies have continued to increase. For example, the same data indicates that in 1980, while life expectancy at birth was 73.7 years, life expectancy for someone age 65 was 16.4 years, or age 81.4.

Increased life expectancy has resulted in some other issues that are important to retirement planning and individuals' efforts to have a financially secured retirement. These issues include the participants' appreciation of the impact of increased longevity on their financial security in retirement, participants' ability to understand and manage their retirement funds with declining age and cognitive ability, unexpected increased health care costs, and change in lifestyle in their retirement years. Some of the witnesses testified that there is a significant probability that retirement funds will need to last retirees as much as 30 years.

2. Evolving Market and Innovation for Income Replacement Options

Another aspect of this shift in retirement coverage is the growing need for employers who want to provide their workers with a secured retirement to examine and analyze lifetime income options designed to address their workers' retirement financial needs. In addition, there is the need for educational materials and outreach efforts that are designed to assist participants in understanding the importance of being able to convert their account balances into a steady stream of retirement income.

In responding to this need, some employers offer annuity distribution options, either through commercial annuities that are incorporated within the DC plan, or via transfers to a DB plan sponsored by the same employer as lifetime income distribution options. Another option is to provide the participant access to the account balance. In these cases, the participant can elect to withdraw the account balance where the account balance is paid either directly to the individual or rolled over to an Individual Retirement Account (IRA), or leave his/her account balance in the plan.

Often, when a participant elects to withdraw the account balance, in whole or by installments, this option is generally exercised without understanding the impact of this approach on whether the account balance will last throughout his/her retirement years. In some cases, a participant will elect to receive a lump sum distribution. In these cases, generally, little planning, if any, is done to ensure that the accumulated savings are transferred to an option designed to ensure that there is a stream of income paid over the participant's (or beneficiary's) retirement years.

In instances where the participant elects to leave the account balance in the plan, he/she can be faced with multiple options regarding how to improve his/her chances that the account balance will last for an elected period, including over his/her retirement years. These options can range from taking withdrawals (scheduled, unscheduled, or both) to annuitizing the account balance (partial or total; immediate or deferred; etc...), or additional alternatives that fall within the middle of this range. Generally, the availability of these options raises some important questions for fiduciaries and plan sponsors, including, but not limited to:

- Whether the plan should focus on providing a single option or multiple options in an effort to adequately address the different needs of participants, including diversification;
- The major factors to be considered by the plan sponsor in making these options available; and
- Whether there are additional fiduciary considerations raised by making various options available, and the prudent management of these issues while adequately assisting plan participants.

In the testimony presented to the Council, witnesses noted that the retirement product market is beginning to respond to the need for income replacement options within a DC retirement system. The witnesses stated that the market is still evolving and requested that any guidance provided by DOL be designed to allow for innovation in this area. Some of the products that are available in the market, and were discussed by the witnesses and Council members include:¹

Traditional annuities. This product may be the most readily recognized because of the length of time it has been available (around for decades), and its exposure on the market (promoted both in and outside of plans). Under this product, the participant purchases the right

¹ See testimony of Bruce Ashton, Drinker Biddle & Reath LLP; Michael Hadley, Davis & Harmon LLP; Article: Lifetime Income in Defined Contribution Plans: A Fiduciary Approach (A White Paper by Fred Reish, Bruce Ashton and Joseph Faucher)

from the insurer to receive monthly payments. The payments can be selected to be paid over the life of the participant and/or spouse, or for a selected period of time. Current payout rates under this product reflect the historically low interest rates and might average between 6-7 percent of the premium payment. Payout rates in higher interest rate environments can also be materially higher.

The major advantage of this product is that it can provide payments which are guaranteed for the lifetime of the participant. This is accomplished by pooling the risk that the participant will live beyond his or her life expectancy with the same risks for other individuals. The result is generally a lower cost to the participant, or alternatively a higher withdrawal than if he or she would have if solely responsible, on an individual basis, for making the assets last as long as the participant lived. To obtain this benefit, however, the participant generally must relinquish control over the funds at the point of purchase. Product variations that include some level of liquidity, however, also generally feature a higher cost.

Guaranteed minimum withdrawal benefits features. These products are often referred to as GMWBs, and represent a hybrid product with combined features. It generally consists of a mutual fund (such as a balanced or target date fund) or a similar investment product, and the guaranteed minimum withdrawal feature which is designed by the insurer. In exchange for premium payments, the insurer guarantees the participant payments that are equal to a percentage of the benefit base. The payments are initially made against the account balance and by the insurance company after the account is depleted. The payout rate can vary, but generally averages 5 percent (or 4.5 percent if there is joint life guarantee) of the investment amount. The guarantee is conditioned on the requirement that the participant not withdraw more than the specified amount per year. Withdrawals that exceed the stipulated amount will decrease the benefit base for determining future payments.

The major advantages of this product are (1) the flexibility for the participant to retain ownership of, and can access to, his/her investments and (2) the ability of the participant to pass any remaining cash value in the account to his/her heirs. The disadvantage is the requirement to adhere to a specified withdrawal annual amount which is generally less than payments under a traditional annuity.

Longevity insurance: this is an insurance product that is generally designed to begin payments when the participant reaches a specified age, often age 85. The insurance product can be combined with other retirement income approaches that are intended to address the income needs before the participant reaches the payout age under the insurance product.

The major advantage of this product is that the premiums are generally lower than other types of annuities. The disadvantage is that if the insured risk does not occur, i.e., the participant does not live to reach the stipulated age, the investment in the contract is lost.

Managed payout and retirement income mutual funds: these are typically mutual fund products (not insurance) and are designed to provide a steady stream of retirement income while allowing the participant access to the funds. Payments are made, generally monthly, at a specified rate that represents an average of 3-7 percent of the principal. There are two basic

types of managed payout funds: (1) defined term funds, and (2) defined payout funds.

Both types of funds are dependent on the principal and investment returns. (1) The defined term fund is designed to provide payments over a set period of time. The payments are based on the invested principal and investment returns. Payments are not guaranteed but are designed to keep pace with inflation, and can fluctuate over time depending on investment performance. (2) The defined payout fund is designed to provide a specified payment that is a percentage of the invested capital. This amount is generally set as an annual payout and usually paid from investment returns. However, the investment manager can generally opt to invade the principal if necessary to meet payments amounts. The period of time over which payments are made will depend on the investment performance of the fund.

This type of product usually cannot guarantee that payments will last for a specified period of time or for the participant's life. Thus, these products do not solve the issue of longevity if the participant outlives his/her investment. The advantage of these options is lower costs because there is no guarantee feature.

Managed retirement income accounts. This is not a product. Rather, it is a service where a professional money manager undertakes to manage the participant's account with the goal of preserving the invested capital. The manager will oversee the monthly payments, and will often recommend that the participant purchase longevity insurance.

The major advantage of this service is the ability of the participant to retain control of his/her account and can cease or increase payments when so desired. The major disadvantage is that this approach does not offer guaranteed lifetime income for the participant.

III. SUMMARY OF TESTIMONY AND COUNCIL DISCUSSION

- 1. DOL 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 guidance/clarification should be designed to reduce current barriers faced by fiduciaries, plan sponsors, and service providers in their efforts to encourage participants to develop post-retirement income strategies and to consider alternatives in offering income replacement options.**

Modification of the Regulatory Safe Harbor for selecting an Annuity Issuer

The Council received much testimony that underscored the importance to the retirement community that DOL develop guidance designed to provide meaningful assistance to plan sponsors and participants through modifying the safe harbor that governs the selection of an annuity as set forth in Regulation Section 2550.404a-4.

Witnesses consistently requested that DOL establish a more definite safe harbor standard to govern the selection of an annuity issuer which in turn would provide greater certainty for plan fiduciaries. The Council recommends that DOL partner with the National Association of

Insurance Commissioners (NAIC) in their effort to examine the appropriateness of one or more of the financial indicators utilized by state insurance departments in their evaluation and ongoing monitoring of domiciled insurance companies, and which could be used as feasible factors in any modified annuity selection safe harbor.

Testimony from many witnesses strongly encouraged DOL to provide guidance on the impact of a fiduciary's duty in evaluating issuers and providers of annuities (or other lifetime income options). In particular, witnesses encouraged and discussed with the Council the importance of modifying the annuity provider selection safe harbor within Regulation Section 2550.404a-4². In addition, Mr. Jeffrey Turner, with the Office of Regulations and Interpretations, when addressing the Department's work in the area of lifetime income options, acknowledged that public comments support further consideration or action in three distinct areas, the third of which is a review of the fiduciary standards applicable to the selection of annuity providers in DC plans as it relates to the regulatory safe harbor standards.

In its statement submitted for the record, ACLI stated that many of the concerns that currently impede employer's selection of lifetime income options are a byproduct of perceived fiduciary risk. They further stated that it is difficult to overstate the high level of concern about fiduciary liability with respect to such selection. However, it was acknowledged that a position taken in the final regulations on the selection of annuity providers for distributions from DC plans, at 29 CFR §2550.404a-4, were considered an improvement from Interpretive Bulletin 95-1³. ACLI noted that the clarification made by DOL that "the safest available annuity standard" does not

² §2550.404a-4

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.
- (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 section, 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).

³ Interpretive Bulletin 95-1 set forth in general that ERISA's standard of prudence required that a plan fiduciary select the safest available annuity provider, unless under the circumstances it would be in the interest of the participants and beneficiaries to do otherwise. The Bulletin also provided general guidance when it may be in the interest of the participants and beneficiaries to purchase other than the safest available annuity.

apply to DC plans was an extremely positive first step to reducing the magnitude of the fiduciary liability impediment, but that additional guidance is needed. ACLI urged DOL to adopt rules and regulations to make the duties of employers in selecting providers of guaranteed lifetime income products similar to employers' duties in selecting providers of life insurance, disability insurance, or other financial protection products.

ACLI further set forth the following standards that should be incorporated in the modified safe harbor with respect to the fiduciary:

1. The fiduciary should engage in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;
2. The fiduciary should appropriately consider and conclude, at the time of selection, that the cost (including fees and commissions) of the annuity contract is reasonable in relation to the benefits and administrative services to be provided; and
3. If necessary, the fiduciary should consult with an appropriate expert or experts for purposes of compliance with safe harbor provisions.

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

In his testimony, Mr. Kevin Hanney, with United Technologies, stated that it is critical for the regulatory agencies to promote a clear and reasonable standard of care for plan sponsors and fiduciaries. He noted that while many will endeavor to develop best-in-class practices as it relates to the design, evaluation, selection, and oversight of income replacement solutions, few will devote their valuable resources to the effort in the absence of a clear and reasonable standard of care. He noted in the absence of such guidance, there exists a very real risk that the plan sponsor and/or fiduciary would be criticized and second-guessed in the event of that unforeseen, unfortunate and unavoidable conditions arise. He noted that the regulatory agencies were well positioned to provide the necessary level of confidence to well-intentioned and procedurally prudent fiduciaries by issuing, and clearly and consistently communicating, a process-focused standard of care for the evaluation, selection and monitoring of income replacement solutions.

In addressing some of the shortcomings of the existing safe harbor, Mr. Ashton, of Drinker Biddle, noted that it does not provide sufficient detail to be a valuable tool for the average plan fiduciary. He noted that it does not clearly address the type of information that should be considered in assessing the ability of an annuity provider to make future payments. In addition, he noted that the safe harbor does not address other retirement income options outside an annuity product. He stated that while the process set forth in the safe harbor regulation would presumably be the same for the selection of other products that it would be helpful if DOL would clarify this.

Mr. Michael Hadley, of Davis and Harmon LLP, is another witness who spoke to this issue and noted that “it is not, and should not be, the law that offering an annuity distribution turns plan fiduciaries into stop-loss guarantors of insurers whose financial condition unexpectedly deteriorates despite the watchful eyes of state insurance commissioners.” He noted that it is incumbent upon policymakers –and the attorneys that advise plan fiduciaries – to remove any uncertainty on this point. As noted above, many witnesses focused on review and selection of annuity options, with much attention being focused on meaningful uncertainties many fiduciaries encounter in trying to comply with the annuity selection safe harbor. Witnesses cited this as a significant reason why more employers do not make an annuity option available under the plan. Witnesses stated that the current rule provides less of a safe harbor and more of a statement that the plan fiduciary must predict the financial viability to the annuity issuer not only at the time of purchase, but for the life of the annuity. Some witnesses recommended that plan sponsors be allowed to rely solely on the fact that the annuity issuer is licensed under the state insurance laws and is permitted to conduct business in the state. On the other hand, other witnesses requested that DOL seek insights from the NAIC to identify helpful criteria that could serve as the basis for a safe harbor.

Ms. Julie McPeak testified on behalf of the NAIC and provided an overview of the level of oversight the State insurance regulators engage in with respect to the life insurance and annuity providers domiciled in their particular state and the states in which they are licensed to conduct business. She noted that each life insurance company is subject to minimum valuation requirements, Standard Valuation Law and periodic financial stress tests. She also noted that each life insurance company is required to file a number of financial documents (some annually and others quarterly). In addition, she noted that regulators, at least quarterly, assess certain aspects of the company’s business including reserve adequacy, leverage, liquidity and surplus. Commissioner McPeak indicated that she thought some of these documents and processes would be helpful in the evaluation process.

In response to a question from the Council, Ms. McPeak 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. Instead, she noted that plan sponsors and fiduciaries should take into account the extensive oversight regimen each state has in place to examine and monitor the on-going financial viability of the company. She noted that NAIC’s Life Insurance and Annuities (A) committee recently formed a working group to examine and analyze options that would be helpful to employers becoming more confident with the financial viability of annuity providers as included in a safe harbor developed by DOL. Ms. McPeak expressed great interest in working with DOL in this effort.

The Council believes that this partnership could be extremely helpful to DOL in their effort to develop a more workable safe harbor for the selection of annuities and other lifetime income products and would encourage DOL to develop this partnership with NAIC on this issue.

Needed Clarification to Promote Participant Education and Advice on Income Replacement Options

Testimony from multiple witnesses stressed the importance of education for plan participants in understanding the challenges of ensuring financial security during the retirement years when retirement savings is through a DC plan. Witnesses noted the importance of sensitizing plan participants to the challenges of managing the lifetime decumulation of retirement savings, particularly given the significant unknown element - how long the individual and/or spouse will live. The risk of exhausting all retirement assets during the participant's lifetime was stressed in much of the testimony.

Mr. Bruce Ashton testified that more and more workers will face significant risks in retirement, leading to what some have referred to as the post-retirement crisis. Included in these risks is the significant statistical probability that individuals will live longer in retirement than they expect. He further testified that few participants understand how long they can expect to live after retirement, and thus how much money they will need for retirement. He noted that there is a significant probability that retirement funds will need to last for as much as 30 years. This, he said, is a high probability that participants can hardly afford to ignore.

Mr. Jonathan Forman, a professor of Law with University of Oklahoma, in a written submission commented on the risk of participants outliving their retirement savings. He noted that the greatest risk facing current and future retirees with a DC plan is the risk of outliving one's retirement savings. He noted that as life expectancy increases, accumulated retirement savings in individual accounts will need to finance an even greater portion of retirees' ever-longer retirements. He cited the following data: "at present, a 65 year-old woman has an even chance of living past age 86, while a 65 year-old man has an even chance of living past age 84."⁴ Also, he noted that today's college students have a 50-50 chance of living to age 100."⁵

Knowing that retirement is likely to be longer than most participants anticipate, and that the money accumulated in the DC plan will be a significant portion, if not substantially all, of the participant's retirement funds, it is imperative that participants begin to view their DC plan retirement funds not as just an accumulation of savings, but a pot of money that must be managed in a way to provide replacement of salary, wages, and other compensation during the participants' retirement years and over their lifetime.

Mr. Kevin Hanney testified that United Technologies Corporation (UTC) recognized the challenge for most plan participants is to grasp a firm understanding of what is necessary for them to construct and implement a savings and investment program during their working years, and subsequently adhere to a disciplined spending program in retirement that when combined is sufficient to sustain a level of income comparable to their salary, wages and other compensation. He noted that UTC decided that participant education should be underpinned with plan features

⁴ Board of Trustees, Federal Old-age and Survivors Insurance and Federal Disability Insurance Trust Funds, 2012 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds 91 (tbl. V.A4) (2012)

⁵ Robert F. Fogel, *Forward: Toward and Era of Longevity and Wealth*, in *Lessons From Pension Reform In the Americas* 1,4 (Stephen J. Kay & Tapen Sinha, eds., 2008)

designed to address key employee challenges. To this end, UTC adopted a Lifetime Income Strategy, which is promoted with increased education among their employees.

The Council recognizes that UTC is among the larger employers and therefore does not necessarily set the tone for smaller employers. However, the Council does recognize the critical need for employer involvement if efforts to ensure that workers have a source of lifetime income during retirement years are to succeed. In that regard, the Council sought testimony to determine whether there were specific barriers preventing employers from becoming more involved and providing education to participant on possible investments and distribution options for lifetime income. The Council received testimony on the barriers employers currently face in this effort.

Witnesses identified critical barriers that many employers and service providers face in their effort to adopt greater education tools and distribution options to enable better participant retirement planning.

The Council heard testimony that many employers and service providers rely upon existing DOL guidance applicable to education and guidance to provide important programs to participants. However, witnesses expressed concerns with this approach because this guidance has not been clarified or updated to specifically apply to education and advice on distribution options to ensure lifetime income under a DC plan.

ACLI's statement for the record submitted on June 13, 2012 noted that many employers are hesitant to provide educational information and advice regarding lifetime income options or other arrangements designed to provide an income stream during retirement because of their fear that fiduciary liability would apply to such education and advice. ACLI requested that fiduciaries be afforded protection for the dissemination of information on lifetime distribution options, whether offered under the plan or outside the plan. ACLI reiterated the recommendation that DOL expand Interpretive Bulletin 96-1 to explicitly cover education regarding decumulation strategies such as lifetime income options. ACLI noted that a model notice may prove to be helpful to plan sponsors.

Witnesses noted that plan sponsors are concerned about the ability to utilize many of the same tools permitted under Interpretive Bulletin 96-1, without explicit confirmation from DOL that such reliance is appropriate. Interpretive Bulletin 96-1 was adopted in 1996 to provide the views of DOL concerning participants' directed plans and the circumstances under which providing investment related information would not be considered "investment advice" for ERISA purposes with respect to participants and beneficiaries. The Bulletin identified categories of information and materials under such plans that do not constitute providing investment advice, to invoke the application of "fiduciary" under ERISA section 3(21)(A)(ii) and its corresponding regulation under 29 CFR §2510.3-21(c)(1).

On this issue, Mr. Hanney with UTC stated that the one approach to immediately improve clarity for plan sponsors and plan services providers is to update language in existing guidance to reflect recent product developments and to which products it applies. Mr. Jeffrey Turner, Deputy Director of the Office of Regulations and Interpretations, acknowledged in his testimony that, in the context of DOL's Lifetime Income initiative and in the interest of providing guidance on the

education of employees about lifetime income options, the Department is considering an expansion in scope to IB 96-1. Witnesses noted that absent such guidance and clarification, materials and resources intended as participant education could be characterized as investment advice. Similarly, witnesses acknowledged that existing DOL guidance that validates an investment advisory program as being “conflict-free” does not take into account the aspect of plan distributions that can include the selection of lifetime income products including immediate or deferred annuities. Consistent with the recommendations of the witnesses, the Council recommends that DOL provide such confirmations and clarifications.

Many of the witnesses repeatedly requested that the Council recommend that DOL expand the IB 96-1 to provide guidance and clarification on providing information about distribution options that would not be considered investment advice. More specifically, witnesses asked for guidance and clarification on the information and education that can be provided to participants without triggering the application of the fiduciary requirements. Witnesses requested guidance and clarification on information to participants regarding how to structure payout options and extending the scope of the existing prohibited transaction guidance (such as fee leveling guidance, Advisory Opinion 2001-09A, etc...) to include investment advice relating to distributions and distribution options.

In conclusion, multiple witnesses testified that with appropriate revisions and/or clarifications to these issues plan sponsors and fiduciaries would be more willing to provide education and investment advice regarding distribution options and the decumulation process for participants and beneficiaries under a DC plan, including the range of potential economic risks for participants with respect to selecting certain distribution options and the risks of making their retirement savings last over their retirement years. Witnesses requested that DOL’s guidance and clarification should make providing education and advice investment with respect to the decumulation phase of the participant’s account as available as education and investment advice in the accumulation phase of the account. The witnesses emphasized that the availability of such education and investment advice is crucial to successful lifetime income outcomes for participants.

2. DOL develop more immediate clarification in the same areas in the form of FAQs or other sub-regulatory guidance while DOL examines the recommendation set forth above.

The Council recognizes that the process of issuing regulatory guidance and clarification as set forth in the recommendation discussed above is a deliberate process which could require a significant investment of time and DOL’s resources. Thus, the Council is aware that the recommendation may not be a prime candidate for expedited action. However, the Council also is convinced of the importance of issuing some level of clarification in the near-term to assist the plan sponsor community to be more pro-active in the area of examining, selecting, and offering lifetime income options to their employees. For this reason, the Council recommends that, in the interim, DOL provide guidance on the issues highlighted and discussed under the above recommendation whether in the form of FAQs or other sub-regulatory guidance. The Council believes that this would go a long way to eliminating the current barriers for plan sponsors and their fear of the application of fiduciary liability in an unclear manner, and that plan participants

will benefit from improved education and advice on the consideration and selection of lifetime income products for a secured retirement.

3. DOL develop educational materials to assist employers and plan sponsors in evaluating and selecting income replacement options. The materials should focus on aspects such as:

- 1. The need to accomplish a shift in the perception of DC plans, to include the importance of planning for the decumulation (retirement distribution) process;**
- 2. Commonly applied definitions;**
- 3. Features, designs, risks, and trade-offs;**
- 4. Roles of a plan sponsor/employer when offering income replacement options, education, and advice;**
- 5. Review and evaluation of projection tools used for income replacement stream;**
- 6. Lessons from behavioral finance and research about misconceptions related to income strategies, planning horizons, and understanding longevity risks.**

Modifying the Focus of DC Plans to Include Importance of Planning for Income Replacement During Retirement and Possible Options

As stated in an overwhelming majority of the testimony, current participant education efforts are focused on a participant's accumulation of assets and savings. However, the Council, consistent with witness testimony, believes that plan sponsors need to engage participants with educational materials in understanding the importance of, and how to make their retirement savings last over their retirement years. Certain witnesses noted that record keepers and plan sponsors agreed that adequate retirement income will be the biggest issue under DC plans in the years ahead.

Because the original design and goal of DC plans was to provide supplemental retirement income, the focus of retirement savings in this type of plan traditionally has not included a focus on the ability of plan participants to have lifetime replacement income as an integral part of the plan design. However, the changing role of DC plans to becoming the major (and in many cases the only) source of retirement income for many of today's workers has highlighted the need for DC plans to expand their focus to include providing workers with a secured retirement as one of their major goals. This will involve changing the plan's ultimate structure from solely the accumulation of retirement savings to distribution options that include replacing income over the participant's lifetime.

MetLife conducted a study, "*A Study of Retirement Income Culture Among the FORTUNE 1000*," where a key goal was to measure whether large companies are moving beyond their well-ingrained culture of retirement accumulation toward the creation of a culture that places equal emphasis on retirement accumulation and decumulation of retirement income. Specifically, the study sought to assess the extent to which plan sponsors at the FORTUNE 1000 companies are encouraging and supporting ways for workers to prepare for their income needs in retirement.

In the study, MetLife observed that a substantial majority of plan sponsors appear to recognize the importance of cultivating a retirement philosophy that not only focuses on providing cost-effective retirement benefits that help them remain competitive, but also inculcates the importance of their employees creating retirement income to their futures. However, the study found that despite recognizing the importance of retirement income, plan sponsors remain more focused on retirement savings than on retirement income as a key objective of their programs. In the study, while 93% say that retirement savings is extremely important as a focus of their retirement plans, only 65% say retirement income has a comparable level of importance or their retirement program.

The study found that where plan sponsors have retirement income as a key focus of their philosophy regarding their retirement plan, they are much more likely than other plan sponsors to recognize the ability to generate retirement income as a very important measure of success.

In supporting a need for such a modification, Mr. Srinivas D. Reddy, with Prudential Financial, noted that pursuant to “*Prudential Retirement Plan Participant Survey, 2012*” only one in five participants is “extremely or very” confident that their money will last through retirement. Prudential noted that in two studies they conducted there were three outcome-oriented benefits of shifting the focus to retirement income. The study noted that participants save more, maintain diverse portfolios, and stay the course even in period of high volatility. From the survey Prudential also noted that the data showed that when an in-plan guaranteed retirement income option is offered that participants contributed more.

This data clearly supports the Council’s recommendation that there is a need for plan sponsors and 401(k) providers to provide more participant education that is focused on lifetime income options in DC plans.

Commonly Applied Definitions for Income Replacement Products

As noted throughout this report, there are several alternatives available to plan sponsors and participants in the area of income replacement, including:⁶

- **Fixed Life Annuity**

This product is based on the payment of level income (which may also 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.

- **Variable Life Annuity**

Under this product, income is paid for life. The amount of income varies each year based on the performance of the underlying funds. Consumers can choose allocations among various underlying funds. Under this product, 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.

⁶ More detailed chart provided by TIAA-CREF included in the Appendix.

- **Fixed Period Annuity**
The product has level income amounts (which may also include a COLA) that are paid for a fixed period.
- **Systematic Withdrawals**
This option includes withdrawals taken from a deferred annuity or a retirement fund on a systematic basis. It can be set up to accommodate almost any pattern of income. Once the fund is fully liquidated, income payments cease.
- **Interest Only Withdrawals**
This is a form of systematic withdrawals where the earnings on a retirement fund are paid out as income on a periodic basis.
- **Longevity Insurance**
This option is a lifetime annuity with benefits that start at a specified future date or advanced age (i.e. 85). When used in combination with a systematic withdrawal program from a retirement asset, the combination provides income and the flexibility of an emergency fund for several years in retirement that is followed by fixed lifetime income.
- **Guaranteed Lifetime Withdrawal Benefit (GLWB)**
This is typically in the form of a rider to a variable annuity. It provides a guaranteed withdrawal amount (typically around 5% for a 65 year old) from a deferred annuity account such that once the account is fully liquidated, the guaranteed withdrawal amount continues to be received as long as the consumer lives.
- **Guaranteed Minimum Income Benefit (GMIB)**
This is typically in the form of a rider to a variable annuity. It provides a guaranteed minimum lifetime income amount per \$1,000 of accumulated value, where the accumulated value is guaranteed to increase regardless of the performance of underlying funds.
- **Target Income or Managed Payout Funds**
This is in the form of mutual funds that seek to provide an annual income that is based on a fixed period (where the income varies) or a fixed percentage of original investment (where how long the income will last varies).
- **Lump Sum**
This is in the form of a one-time, single payout of the entire proceeds of a retirement savings account. 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.

Available Income Replacement Alternative - Features, Designs, Risks, Tradeoffs

The Council heard testimony from many witnesses weighing in on this topic with one theme emerging as a consistent message - DOL should develop educational materials to help plan sponsors effectively evaluate and select income replacement options. A major part of effectively evaluating and selecting the income options is understanding the key features, designs, risks, and tradeoffs of the options being considered.

Witnesses provided input on the broad availability of retirement products. In general, the options can be separated into two categories: (1) withdrawal income options (with no lifetime guarantees) and (2) lifetime income with payment guarantees. A major concern with the withdrawal income options is that participants could outlive the payment period designed under the option, whereas, the dominant concern with lifetime income is that the participant has to give up some or all of the control over, and generally access to the assets in the case of an emergency.

Witnesses emphasized that one particular retirement distribution option, an annuity (in its various forms, including: immediate annuities, longevity annuities, joint and survivor annuities, and annuities with various guarantees), though not a solution for every participant's situation, is one of the few options that guarantees income for life.

Mr. Srinvas D. Reddy noted that are a number of options available to DC plan participants with regards to the creation of retirement income, which can be grouped into in-plan versus out-of-plan solutions and best efforts versus guaranteed solutions. He noted in the attempt to address the primary retirement income risk of longevity that there is a tradeoff between the amount of income generated and the level of flexibility and control the participant retains.

Mr. Reddy testified that the primary out-of-plan solution offered through the workplace consist of various immediate annuities, of which fixed immediate payout annuities are predominant. In-plan options, on the other hand, have expanded through innovation over the past several years. He noted that best efforts products include managed payout mutual funds and managed accounts with systematic withdrawal programs. Guaranteed products encompass payout annuities, longevity insurance and hybrid innovations such as guaranteed lifetime (minimum) withdrawal benefit (GLWB/GMWB).

Managed payout funds are essentially mutual fund investments that create ongoing retirement income as the fund's investment objective. The payout rate will determine whether the retirement income is paid with or without preservation of the principal investment. Mr. Srinvas noted that these products may be attractive due to the simplicity of the design or the familiarity of the structure to participants who are familiar with mutual funds. Also, he noted that a significant challenge is to ensure that the plan participant understands that these solutions are not guaranteed and that resulting investment performance and retirement income risk are retained by the participant.

Additional testimony highlighted the lower relative cost of annuitization as a result of the pooling of mortality risks across annuitants, along with the tradeoffs of the corresponding possibility that the participant might die prematurely and forfeit a substantial portion of the annuity purchase. This pooling of risks, witnesses noted, could result in a significant discount on cost up to a 30 percent reduction. Witnesses noted the importance of showing plan sponsors,

fiduciaries, and participants that an annuity provides insurance against exhausting an individual's retirement savings. They also noted a potential for balancing the opposing considerations by including additional guarantees in the annuity for an additional cost.

Role of Employer/Plan Sponsor – Educating Plan Participants, Providing Advice

The Council believes that plan sponsors should adapt their education efforts to engage participants in a dialog to develop a better understanding of how to make their retirement savings last a lifetime. This will be especially important as the wave of the baby-boom generation enters into their retirement years. Education around income replacement will be of paramount importance and will play a pivotal role in increasing the probability of making their assets last throughout their lifetime. The Council heard from many witnesses and was informed that education will not be easy, due to the complex nature of the various lifetime income products and options that are available in the marketplace.

Moreover, witnesses strongly recommended that the educational information allowed explicitly permit the provision of information to employees regarding retirement risks, the definition of a longevity market, inflation, retirement, etc. Also, it was recommended that the educational guidance be permitted to include retirement income models, retirement calculators and annuity illustrations, while avoiding the risk of it being characterized as providing “investment advice” within the meaning of the existing regulations and IB 96-1. The educational information, as proposed, should also include the different types of products offered, their features and risks, and the costs of the income replacement products that may be offered.

The various options and the corresponding complexity can be intimidating to both a plan sponsor as well as plan participants. For this reason, the Council recommends that DOL champion the idea of creating a guide which explains the basic definitions that are used when examining and evaluating lifetime income products. In addition, the guide should include a discussion on the different types of products, features, designs, risks, tradeoffs, and promote the development and adoption of income replacement options.

The Council heard testimony from Ms. Cynthia Mallet of MetLife, who discussed her company's recently released study entitled “*Perspectives of Plan Sponsors and Recordkeepers for Qualified Plans.*” The study explored the dynamics of the plan sponsor and record keeper relationship and the efforts they are making to provide participants with the necessary education, tools, awareness and solutions as well as identify the perceived obstacles to providing retirement income options under DC plans.

Many witnesses agreed that employers would be more inclined to consider offering lifetime income products if DOL would provide more guidance on their roles and responsibilities when offering income replacement options, education, and advice. ACLI, in its submitted testimony, stated that “DOL should clarify that plan assets may be used to educate participants about lifetime income options including those typically available outside of the plan. Without this clarification, plan sponsors, who are in the best position to ensure that participants receive this information, may hesitate to do so and plan service providers may be reluctant to include education on lifetime income as part of their service models.”

Kevin Hanney stated, with respect to clear and reasonable guidance on plan sponsor education, “we respectfully submit that draft guidance issued by relevant regulatory agencies and meaningful comment periods will be crucial to successfully addressing the many issues plan sponsors face.” This information supports the Council’s recommendation that plan sponsors need some guidance and clarity to help them move more fully into the income replacement options area.

Review and Evaluation of Income Replacement Projection Tools

Witnesses also discussed the value of online income tools as an education reference. There appears to be difficulty among participants in understanding their account balances as reflected in terms of a stream of income due, in large part, to the degree of complexity involved in using these income projection tools. For example, assumption rates and the rate of return calculated in the results given to participants are not easily defined and depend largely on the tool used. The Council encourages DOL to develop additional educational materials that would advise participants of the tools available, and guide participants on how to use these tools to their advantage.

The Council was advised that these tools should include a variety of mortality assumptions that a participant can utilize in order to project a broad range of retirement outcomes when evaluating possible options. To that end, the Council encourages DOL to review its online retirement calculator that is already available via its online publication, *Taking the Mystery out of Retirement Planning*, and develop a calculator that provides an estimate of the monthly payment of a lifetime benefit under a particular amount of retirement savings. The use of such a calculator could serve as a general guideline for participants to understand the amount an individual would receive under a specific scenario and could prompt participants to adjust personal savings as needed.

Testimony supported showing participants the projected income stream under their account as well as the accumulated account balances on their benefit statements.

Although using the participant account statement to illustrate the income stream that can be produced by an account balance was supported, in general, by the witnesses, there was considerable disagreement over what details should be provided on the statements. For example, it was debated whether to encourage or mandate illustrations of the income stream and whether the current account balance of the participant was appropriate to provide the projection. Some witnesses advised that plan sponsors did not want a mandate to provide this information to their participants.

Because the Council is aware that DOL is already working on this issue as part of pension benefit statement guidance with the Treasury Department, the Council decided not to make any recommendation with respect to this issue. However, the Council notes that this is an important issue that, if implemented correctly, can go a long way to help in the overall educational process.

Understanding Longevity Risks, Planning Horizons etc.

A significant amount of witness testimony was received expressing the need for educational materials and outreach to assist participants in understanding the complexities of income replacement options. It was expressed that a lack of participant focus on the importance of lifetime income leads to a lack of diversity in investment, low deferral rates and loss aversion. Witnesses recommended that if participants were expected to save a sufficient amount to produce lifetime replacement income then the participants' focus should be on the importance of planning retirement goals. Witnesses testified that participants need to be given basic financial education so that they can better understand how much retirement savings they will need to adequately produce replacement income throughout retirement.

Many witnesses noted that participants lack understanding of the various lifetime income options available to them. Some stated that while participants like the aspect of receiving a steady stream of income for life, with no risk of running out of money, they are concerned about the cost of the products and the aspect of losing control over the funds they must release .

Richard Bailey with VALIC stated, with respect to employers and plan sponsors addressing these issues, that “these types of analyses can be quite complex depending on the circumstances and financial assets of the participant. While the employer may not be obligated to provide more sophisticated planning which could include retirement savings or financial assets outside of the plan, the ability to offer that level of planning may aid the employer in attracting and retaining employees.”

Mr. Hanney testified that “most individuals do not possess the knowledge, resources and/or incentives that are necessary to construct and implement a savings and investment program during their working years...” He further stated that if left to this independently, many individuals underestimate their retirement needs and the level of savings necessary to fund those needs. He noted that at UT they were not mistaken about the level of education an employee needs, and how essential such education was to successful outcomes.

Richard Pretty, with TIAA-CREF, stated that his company's experience has shown that many participants do not understand how much income they will need in retirement, how much they need to save prior to retirement, and fail to properly convert their DC plan retirement savings into adequate income once they reach retirement. He also noted that their research shows that keeping education simple and leveraging “inertia” can help produce better outcomes.

Additionally, some witnesses noted that two common questions from individuals considering lifetime income products are how much to annuitize and the security/safety of insurance companies. Education efforts could be focused on consideration of the participant's total financial picture in determining how much to annuitize. While it is clear that employers will not have access to much of this information, the employer could make the employees aware of the importance to taking a total financial approach to these issues. The issues surrounding the security and safety of providers of lifetime income products is discussed more fully under the recommendation set forth in number one.

DOL's participant education and outreach should include information that is geared towards a typical age period of a participant. The Council recommends that DOL outreach begins with participants as early as possible so that they can more accurately evaluate their retirement income goals. Acknowledging that DOL's current materials reference the need for a participant's retirement portfolio to be diverse, the material should be enhanced to discuss the need to understand portfolio risk and what impact market volatility has on that risk. The guidance should include an overall evaluation of a participant's lifetime income needs, factoring lifestyle choices and other household income, including spousal retirement income, survivorship benefits, etc.

4. DOL develop educational materials to assist individuals in understanding and choosing income replacement options to best suit their retirement needs, including:

- a) The importance of understanding the life-cycle approach to planning;**
- b) Key features, designs, risks, and trade-offs;**
- c) The importance of understanding the tools and assumptions used to project income stream;**
- d) The need to evaluate all household sources of retirement income, including survivor benefits and Social Security;**
- e) The impact of inflation and inflation assumptions;**
- f) Understanding the impact of longevity and longevity risk, the need for a long planning horizon and potential benefits from mortality risk pooling;**
- g) The timing of decisions and alternatives.**

a) The importance of understanding the life-cycle approach to planning.

The Council concluded that DOL should develop life-cycle planning materials to help individuals understand the importance of planning at each stage of their working life. Witnesses testified, and the Council believes, that this type of planning will assist individuals to set retirement goals and generate sufficient lifetime income to cover retirement expenses.

Professor Olivia Mitchell and other witnesses documented the formidable challenge of individuals with DC plans who need to ensure their own retirement security. Many individuals underestimate their retirement needs and the level of savings necessary to fund them. Mr. Reddy with Prudential noted in his testimony that a disproportionate focus on current financial demands, coupled with a lack of education regarding financial needs during retirement, leaves many participants unaware of their true retirement income needs.

As more individuals rely on building savings in defined contribution plans, it becomes even more important to use this planning approach to develop better savings, avoid mistakes and implement a financial strategy that shifts as the individual ages. The Council heard testimony from other witnesses that suggested the importance of continuing to promote savings during the accumulation phase; to provide individuals with benchmarks to help them stay on track to reach the amount they will need to retire; and to know how that savings will translate into monthly payments that will cover their expenses during retirement.

As noted in testimony received, life-cycle planning helps individuals by identifying broad guidelines to help keep them on track to meet their financial goals. The life-cycle approach promotes financial priorities for each stage of life as follows:

- During the early stage of accumulation, **age 25-35**, individuals should begin to contribute to a 401(k) or IRA account, build up an emergency fund and start to save for a down payment for a home. An appropriate benchmark would be to advise individuals that building up their savings contributions to 10-15 percent of salary is the retirement savings goal for their working lives.
- The next stage, **age 35-50**, is the time to be saving as much as possible for retirement, taking advantage of the power of compounding, saving for children's college and achieving a high rate of return on investments.
- Generally, those **age 50-60**, are in their peak earning years. They need to assess where they are in relation to their retirement goals, take full advantage of the catch-up provisions, and begin to evaluate their employer-sponsored plan distribution options. For those **age 60 and older**, both pre-retiree and retirees need to understand their appropriate portfolio risk and make sure that they are protecting themselves against sudden market volatility. e.g., a sudden loss that they will not have the time to make up for in the few years before retirement.

The Council recommends that DOL's participant education and outreach should include information that highlights the retirement saving goals during a typical age period of a participant. The Council further recommends that DOL outreach begins with participants as early as possible so that they can more accurately evaluate their retirement income goals.

b) The key features, designs, risks, and trade-offs.

The Council recommends that DOL provide Tip Sheets on the many different types of lifetime income options that are available and the various risks and tradeoffs of each choice.

The Council received testimony from witnesses that addressed the issue of a lack of understanding of the various lifetime income options, and the differences among the available options. Many witnesses noted that while there is no simple solution to address every individual's concerns about the best lifetime income replacement option for their particular situation, that these decisions are best made with the inclusion of an overall evaluation of a participant's lifetime income needs, factoring lifestyle choices and other household income, including spousal retirement income, survivorship benefits, etc.

Other witnesses noted that the features that appeal most to individuals are those that provide guaranteed income for the rest of one's life with the elimination of the risk of running out of money. However, it was noted that there is some tension for most individuals who either do not want to pay for the elimination of that risk because of the cost or the relinquishment of control, or they do not fully understand the benefits vs. the risks of the product they are purchasing. The features that individuals view as

disadvantages are those where the decision is irrevocable, the product is inflexible and the funds are inaccessible.

Other factors that individuals must consider include the fees, commissions, and other charges associated with each product, as well as the financial health of the insurance provider of the guaranteed income product. The table below⁷ highlights some of the features, designs, risks and tradeoffs of some of the broader categories of income replacement strategies and options:

Features	Income Annuity	Other Products with Guarantees	Withdrawals
Guaranteed income for life	Yes	Yes, but at a lower level than in income annuity	No
Mortality leveraging	Yes	Some	No
Liquidity/access to funds	Not in most products	Yes, within limits	Yes
Remaining account value goes to heirs on death	No	Yes, after fees for guarantees	Yes
Owner can control funds in the account while income is being paid out	No	Yes, within limits	Yes

Source: Society of Actuaries 2012 Decision Brief: Designing a Monthly Paycheck for Retirement

c) The importance of understanding the tools and assumptions used to project income stream.

The Council recommends that DOL develop education materials that would help individuals gain access to, and understand the application of, tools that convert a savings amount/account balance into a lifetime income stream.

Most witnesses stated that DC plans leave individuals with the difficult task of figuring out how to understand their retirement savings goal. Most witnesses agreed that individuals are unprepared for this task and need professional help, including calculations to translate account balances into a steady stream of income. Some of the witnesses expressed concern that even with the availability of some projection tools that many individuals do not have the specialized expertise or access to the skills that would enable them to successfully apply these tools.

⁷ Society of Actuaries 2012 Decision Briefs

It was noted that while there are many retirement planning tools available to help retirees calculate their retirement savings as projected into an income stream, there is a degree of sophistication needed to successfully use these tools and receive an accurate projection. For example, an individual would need to understand the assumptions used with respect to, among other things, the expected rate of return for the underlying investments and the rate of inflation.

The Council acknowledges that DOL's online tool and publication, *Taking the Mystery Out of Retirement Planning*, helps those individuals who are close to retirement (age 50 and older) estimate their retirement savings and evaluate if they are on track for their retirement goals. The Council encourages DOL to modify this online tool to provide options to a broader range of users and allow them to apply the tool to their retirement savings at an earlier age, and enable them to assess the conversion of all or part their employer-based retirement savings into a lifetime or immediate annuity providing for estimated monthly payments under the chosen option. The Council believes that this expanded application will result in helping individuals evaluate their retirement goals more effectively.

d) The need to evaluate all household sources of retirement income, including survivor benefits and Social Security.

Although retirement planning can be challenging for individuals it is important for head of households to put a retirement strategy in place that includes the evaluation of all sources of retirement income. The strategy should include knowledge of which sources of income are in the form of guaranteed lifetime payments, if there is inflation protection on any of the retirement income options, and if there are funds available for emergencies or some other form of flexibility. This "total picture" approach to retirement will require the individual to seek some level of professional help at some point in time, but the Council believes that improved education in the employer-based system could significantly prepare individuals to be better able to successfully approach the "total picture" planning stage.

A major source of retirement income is likely to be from the individual's employer-based plan. If the individual has retirement benefits under a DB plan he/she is more likely to have some form of lifetime income option. If, however, the individual has retirement benefits under a DC plan, the issues discussed in this report will apply, and the individual must take the initiative to seek such lifetime income options. These options may be accessed either through the employer-based plan or outside the plan through, more typically an IRA. Other sources of retirement income include survivor benefits and Social Security benefits. In most cases these benefits are paid in the form of lifetime income options but generally are not protected for inflation. Some witnesses noted that Social Security will be the dominant source of income for many individuals, and for those who have benefits under a DB or DC plan that these sources of income will play a critical role in providing retirement security.

Decisions about *when* to commence benefits, including Social Security benefits, can themselves have a significant impact on the retirement income adequacy for an individual or a couple. For example, for some individuals or couples, delaying the start of Social Security benefits (which might require substitution of other retirement income sources, or even continued work, during

the period of the delay) can provide significant increases in retirement income overall. For others, claiming sooner may better facilitate needed retirement income.

Some witnesses stated that it is also important to note if an individual has a Social Security benefit, a DB plan benefit, access to employer-provided retiree health insurance, and a fully paid home mortgage, there may be a reduced need for additional lifetime income guarantee, as in such a case most of the individual's living expenses would be covered.

e) The impact of inflation and inflation assumptions.

The Council recommends that DOL provide inflation charts with examples on how the inflation factor apply to certain products in order to help individuals understand the importance of planning for the effect of inflation during the retirement years.

Stephen Sexauer highlighted the five dominant risks which affect individuals: the risk of not saving enough; longevity risk or outliving savings; investment risk including inflation risk; counterparty risk; and liquidity risk. He noted that inflation becomes a major issue as people spend more time in retirement. Olivia Mitchell noted that it is also a primary risk that many individuals ignore. She stated that it is important for individuals to be made aware of how the inflation risk will substantially reduce their purchasing power and threaten their long-term financial security in retirement. Thus, it is important for individuals to have inflation protected income options to enable the individuals to maintain their standard of living in retirement.

Some witnesses spoke to the importance for individuals to know the impact of medical care and medical costs in retirement, and pointed out that medical care has a higher inflation rate than the annual U.S. inflation rate. The witnesses also noted that many individuals underestimate the high costs associated with medical care in their retirement years.

f) Understanding of longevity and longevity risk and the need for a long planning horizon. Potential benefits from mortality risk pooling.

The Council recommends that DOL develop education materials that focus specifically on, and are designed to encourage individuals to incorporate, the long-term aspect of retirement planning. The materials should provide an explanation of the impact of longevity risk on lifetime retirement security. Longevity risk in this context is defined as the risk that participants will outlive their assets and run out of money during retirement. Also, the materials should address the potential benefit of risk pooling.

Most witnesses agreed that many individuals do not know how to manage the risks of longevity, and that there are gaps in the knowledge individuals have that prevent them from effectively dealing with these risks. Kevin Hanney's testimony suggests that the Lifetime Income program established by United Technologies provides evidence that offering a lifetime option to participants that is accessible throughout the accumulation phase is an important way to increase annuitization by plan participants. This behavior was also confirmed by testimony from Richard Pretty with TIAA-CREF.

Mr. Sexauer reminded the Council that there is no risk-free solution to retirement income and while we can point out the risks and the decisions involved in managing the risks in order to get retirees to where they need to be, there is a need for longevity pooling which provides large gains and up to 30% fewer assets needed to fund a given level of retirement income. During the discussion sessions, the Council was made aware that participants do not focus on the mortality pooling issue but discovered that it is an opportunity to achieve a superior return on the investment if they outlive others in the pooled lives. He noted, along with Olivia Mitchell and Kelli Hueler, that participants generally focus more on losing control of their money and dying before the projected age. Ms. Mitchell noted that pooling was a good investment return and that the risks were worthy of insuring. She noted that insuring longevity risk was as important as purchasing automobile or home insurance, yet people more readily accept purchasing these other forms of insurance.

As part of the education effort, Mr. Sexauer also suggested establishing a decumulation benchmark to minimize the four major risks involved in decumulation: longevity, investment (including inflation), counter-party and liquidity risks. Two additional risks were added to the Council's discussion: the sequence of returns risk and the cognitive risk.

The sequence of return is the risk an individual may encounter if he/she uses the drawdown decumulation method. The sequence of the returns the individual would receive over the drawdown period has a significant impact on how long the asset will last. For example, the individual may be withdrawing amounts equal to 5 percent a year, but if there is a negative performance in the asset early in the drawdown phase it will have a significant impact on how long that asset will last versus if the negative returns occur later during the drawdown period.

Also, there is cognitive risk. Cognitive risk affects the consumer or retiree if individuals are making decisions throughout retirement with respect to how they are drawing down their income. At an older-age, illnesses may come into play and the cognitive risk issue becomes very important and difficult to manage. Addressing this risk in the selected option is another positive aspect of a guaranteed income product – eliminating the need to make decisions on how to structure the drawdown features during a period when the individual's cognitive ability is compromised.

g) The timing of decisions and alternatives.

The Council recommends that DOL provide education on the key decisions people will face in evaluating their retirement needs including when to initiate retirement payments, what forms of payments to select, and how to get the most from their retirement dollars.

The Council is aware of the overwhelming complexity of evaluating and making effective retirement decisions and that these decisions are unique to each individual. In addition, the Council is aware that analysis and these decisions are beyond the average individual's ability to assess all the relevant risks. Several witnesses mentioned this almost universal problem and acknowledged that the wrong decisions will lead to bad retirement outcomes.

Decisions about when to commence Social Security benefits was highlighted by witnesses (including Olivia Mitchell and Kevin Hanney) as having a potentially significant impact on the retirement income adequacy for an individual or a couple. For some individuals or couples, delaying the start of these benefits (which might require substitution of other retirement income sources, or even continued work, during the period of the delay) can provide significant increases in overall retirement income but for others, claiming these benefits sooner may be the best option to facilitate needed retirement income.

Mr. Sexauer's testimony included a suggestion for a public benchmark to help individuals make an informed choice, measure risks and compare and react to events to help them make better future choices

Other Important Issues

The Council notes the issues highlighted below as issues that received a great deal of attention and discussion during the deliberation of the income replacement topic. The Council could not reach a consensus on whether to include these issues as recommendations, in large part, because resolution of these issues will require an involved process either by DOL, the retirement community, and/or a future Council. However, the Council believes it was necessary to mention the following issues as being fully discussed.

A. Auto enrollment or other default features for income replacement option which could include a safe harbor:

The Council heard testimony suggesting the DOL look into the feasibility of adding an auto-enrollment or other default type features for income replacement options which could include a safe harbor option.

Mr. Kevin Hanney, from United Technologies Corporation, suggested the concept of a Qualified Retirement Income Alternative ("QRIA"), which would be designed to achieve the goal of developing and adopting effective income replacement solutions. In addition, the issue of offering a default annuity was also addressed in a June 2011 Government Accountability Office (GAO) report titled "*Retirement Income -Ensuring Income throughout Retirement Requires Difficult Choices.*" The report states that with the declining availability of DB plans and the lifetime retirement income they frequently provide, a default annuity offered within DC plans could help to promote lifetime retirement income for more participants. However, the report did acknowledge there are a few disadvantages with default annuities, such as irreversibility of the election of the option, and/or financial penalties.

Recognizing the success of the current auto enrollment and escalation approaches being adopted and utilized by plan sponsors, the Council believes that the concept of auto enrollment features for income replacement options under DC plans merits further study.

B. Barriers to plan sponsor acting as a facilitator of income replacement options outside an employer-sponsored plan.

The Council heard testimony regarding the possibility of plan sponsors acting as a facilitator of income replacement options that are offered outside the scope of an employer-sponsored plan. Many of the witnesses testified that the option of participants purchasing an annuity outside an employer-sponsored plan can be very expensive because it is often purchased on an individual basis.

The Council believes that plan sponsors and participants could benefit from further exploration of this concept that would examine ways an employer could assist participant gain access to these options, as well as influence the purchase structure of the benefit for participants.

C. Income illustration of account balances translated as a lifetime stream of income.

Many witnesses testified that it would be very helpful to participants if their account balance is illustrated as a potential income stream on their benefit statements. The witnesses shared their thoughts during the discussion period that this would be more likely to get participants thinking about how their account balance could provide them with replacement income during retirement.

The Council noted that this is an issue that DOL is currently working on. Therefore, the Council notes that the issue was discussed by witnesses and Council members but the Council refrains from making any further recommendations or suggestions.

V. CONCLUSION

After receiving testimony and extensive deliberations, the Council concluded that the efforts necessary to sustain lifetime income for a participant in a retirement plan will take a cooperative effort between the plan sponsor and the participant. As part of the effort, participants should be made to recognize the risks inherent in DC plans that did not necessarily exist in more traditional DB plans, specifically, that participants may spend down their assets before their death.

Therefore, guidance by way of educational information offered by a plan sponsor is necessary but the effect on fiduciary responsibility for plan sponsors providing this information appears to be hindering this progress. Moreover, offering lifetime income options may resolve the underlying issue regarding the spend-down of assets. However, a lack of concrete guidance on whether exemptions from fiduciary liability exist for the plan sponsor is preventing many sponsors from offering these options to their employees.

It is the view of the Council that the prospect of a participant not maintaining a lifetime income stream from his or her retirement plan is a serious issue. It is because of this risk that the Council has made the recommendations contained in this report.

APPENDIX A: WITNESS SUMMARIES

Jeffrey Turner

Deputy Director, Office of Regulations and Interpretations Employee Benefits Security Administration, Department of Labor

Jeffrey Turner, Deputy Director of the Office of Regulations and Interpretations, testified for the Employee Benefits Security Administration of the Department of Labor. Mr. Turner thanked the Advisory Council for addressing the issue of income replacement in a DC system and stated that these issues are important to the Department.

Mr. Turner noted that while the decision about including a retirement income product is a settlor, non-fiduciary act, the implementation of the decision is a fiduciary function requiring exercise of fiduciary responsibility. Citing FAB 2007-01, he noted that a fiduciary selecting an investment services provider must engage in a process to review quality of service and fees, as well as potential conflicts of interest. In the context of traditional annuities, he noted the importance of the long-term viability of the provider while acknowledging this may be less important where the choice of an annuity can be changed by the participant. He noted the concerns regarding DOL's regulatory safe harbor on annuity selection, and commented on the low take-up rate of annuities when offered to participants.

Mr. Turner discussed DOL's lifetime income initiative under which they are considering ways to facilitate the provision of lifetime income options in both DC plans and individual retirement accounts (IRAs). He noted the effort included a joint Request for Information that was issued with the Treasury Department. He stated they received more than 700 written comments, conducted two days of public hearings, and received testimony from 45 witnesses. The response suggested action in three different areas:

- Using the participant account statement to illustrate an income stream that could be produced from a given account balance. He noted that there was widespread support for this concept but considerable disagreement over the details to be included. He stated that DOL is working on this issue and hoped that guidance would be issued soon.
- Clarifying the ability of employers to educate their employees about lifetime income options, including possibly amending IB 96-1 (which clarifies that providing education is not considered providing investment advice) to cover education about the spenddown phase. Education about the spend-down phase, according to commenters, could include information on the benefits and risks of annuities, longevity risk, interactive tools, and the benefits and risks of in-plan vs. out-of-plan solutions.
- Reviewing the annuity provider selection safe harbor for defined contribution plans..

DOL is looking into each of these areas but intends to start with educational initiatives: lifetime income illustrations in pension benefit statements and IB 96-1.

Dr. Olivia S. Mitchell
Professor of Insurance, Risk Management, Business Economics & Policy
The Wharton School; Director, Pension Research Council and Boettner Center for
Pensions & Retirement Security

In written and oral testimony, Dr. Mitchell explained the issues of longevity risk; distinguished annuities from other forms of investments; identified some of the challenges plan sponsors face; and made a number of recommendations concerning how lifetime income options are presented.

Longevity Risk: Dr. Mitchell confirmed that annuities offer longevity risk protection, so people don't outlive their assets. She noted that approximately half of individuals outlive their life expectancy but that mortality varies depending on occupation, race, gender, and other factors. Thereby, making annuitization more, or less, attractive for certain identifiable groups. That some individuals fail to annuitize because they underestimate the chances they will live a long time. She noted that an annuity is not only an investment product, but also insurance of longevity risk, peace of mind, and income protection. She stated that this form of insurance was as important as home owners or automobile insurance, yet individuals were more willing to insure these risks than the risk of outliving their retirement assets.

Choice of Payout Alternatives: Dr. Mitchell highlighted the lack of behavioral economic studies that confirm the impact of a lifetime income payout "default." She noted that while an annuity/lifetime income product provides protection against outliving assets, phased distribution alternatives offer flexibility with each option providing benefits and restrictions. Dr. Mitchell noted that few DC plans offer annuities, and many defined benefit pensions offer lump sums.

Recommendations: Dr. Mitchell recommended that (1) more plan sponsors offer lifetime income options once new safe harbors/guidelines are issued; (2) communicating with regards to lifetime income issues should include information on both immediate and deferred payouts. She noted that educational materials should express financial information in dollar terms rather than percentages because research suggests that participants better understand dollar terms over percentages.

She noted that individual benefit statement or projection of income stream could be wildly off target due to a lack of information, and should include as much specific information as possible. She stated that because the need for lifetime income is increasing as Baby Boomers retire, there need to be changes to enhance the appeal of annuities which can be accomplished, perhaps through increased financial literacy, greater transparency, and other educational means.

With respect to receiving Social Security benefits, Dr. Mitchell noted that Social Security is the best annuitized lifetime income option available to participants. She noted that one of the greatest investment return is to delay the receipt of Social Security benefits until the participant reaches age 70. She noted that a Social Security study showed how claiming rates are affected by how the benefits are presented; Social Security claiming rates accelerated by two years where a "break-even" approach was used.

Bruce Ashton
Partner
Drinker Biddle & Reath

Mr. Ashton testified with regards to why he believed post-retirement income replacement or income protection options were necessary and the policy and legal issues that should be considered with respect to such options. He noted the importance of encouraging the development and use of these options in light of the increased potential for people to outlive their retirement savings. He also noted that cognitive impairment was a key issue. In addition, he stated that most employees have misconceptions regarding how long a single lump sum of money will last, an outgrowth, he sees, from the DC plan retirement system.

Mr. Ashton noted three areas on which policy makers, employees and employers should focus to address the lack of adequate retirement income throughout an employee's lifetime.

- Participant Education: Employees need to be given basic financial education to help them better understand how much retirement savings they will need to sustain them throughout their retirement. One way to accomplish this, he noted, would be to include projections on benefit statements which he believes are generally a good communication vehicle. In addition, he also noted that regulatory safe harbors would help encourage education efforts.
- Employer Education: Employers need to better understand that their employees will not have enough savings at retirement to last until their deaths. Furthermore, he noted, employers do not appear to be aware of, or interested in, the income protection and replacement options currently available in the marketplace.
- Regulatory Environment: The regulatory environment should promote flexibility. Mandates in his area would likely not be effective due to the vast array of products, providers, plans, and employers involved. He stated that he tends to favor "in-plan" options because their use could be promoted under the plan. He further stated that in order to encourage implementation by employers clarity is necessary regarding (i) the fiduciary issues surrounding adopting or implementing lifetime income solutions and (ii) portability of products including the ability to move the benefit from one plan to another, and to activate the benefit at retirement.

Mr. Ashton noted that a key part of the legal analysis underlying income protection solutions is determining whether the products should be analyzed as a distribution option or an investment option. He noted that Section 404(c)'s fiduciary protections for participant-directed investment decisions and for qualified default investment alternatives could be useful. In addition, he stated that he did not believe a formulaic safe harbor would work in the area of selecting and implementing income protection solutions because of the variety of products and services. Rather, he recommended "soft guidance" regarding what DOL believes would be appropriate factors in considering products, and providers and making other decisions would be very helpful and encourage adoption of this approach.

Michael Hadley
Partner
Davis & Harman

Mr. Hadley primarily focused on the legal uncertainties that exist in the area of adopting both “in-plan” and “out-of-plan” income protection options. He noted that while legal uncertainty is not the only reason a lot of employers have not implemented the options, removal of existing legal uncertainty is immediately actionable by policy makers and could yield positive results.

Mr. Hadley discussed several topics that can be addressed by the Department of Labor including the following:

- Clarification of the “plan asset” status of annuity contracts once distributed from the plan.

Provide guidance on the extent of a fiduciary’s duty in evaluating providers (e.g. insurance companies). He noted that ERISA does not require fiduciaries to have a “crystal ball” and that the recent final regulations on selection of annuity providers for distributions from DC plans (29 C.F.R. § 2550.404a-4) are informative and an improvement over the regulations on selecting annuity providers (Interpretive Bulletin 95-1). He encouraged DOL to remove the requirement from its regulations that fiduciaries determine the financial viability of providers by requiring an evaluation as to their ability to pay benefits in the future. He noted that this is an unreasonable expectation of fiduciaries and is an unnecessary requirement in light of the extensive regulation of the insurance industry.

- Provide a safe harbor to allow plans sponsors to provide education on distribution options. He noted that DOL Interpretive Bulletin 96-1, which addresses when providing investment-related information to participants in the accumulation phase is investment education rather than investment advice for ERISA purposes, has been a success. He pointed out that this guidance does not apply to education on the distribution phase.

Mr. Hadley indicated that a formulaic safe harbor for purposes of selecting annuity providers would be more helpful than procedure-oriented guidance. He noted that “soft guidance” directing fiduciaries on what to consider was not helpful if they were not told what to do with the considerations. He stated that in general, fiduciary safe harbors should be as specific as possible. He also noted that the regulations under section 404(c) of ERISA may also be amended to provide safe harbors with respect to retirement income protection options.

**Abigail Pancoast, Lincoln Financial Group,
Appearing for the American Council of Life Insurers (ACLI),
Chair of the Retirement Plans Committee**

As set forth in the testimony, ACLI members offer income products to plans and to individuals for their IRAs. The testimony outlines a variety of different types of annuities as well as defines key terms. In addition, the testimony discusses factors considered in pricing and provides some background on insurance regulation. The testimony points out with respect to the annuities, the expense charges and expected profit are embedded in the price, not separately disclosed. The testimony points out the value and importance of annuities. ACLI encouraged support for the development of product innovation, including the incrementally purchased payout annuity and the Guaranteed Minimum Withdrawal Benefit (GMWB).

The ACLI testimony recognized as impediments to annuity utilization plan sponsor concerns about fiduciary liability, administrative issues, and lack of participant knowledge. The testimony set forth a number of suggestions for Council recommendations to DOL.

The testimony proposes that IB 96-1 be expanded to clarify that providing information about payout options is not investment advice, and that plan assets can be used to offer education on payout options.

The testimony proposed changes to the requirements for selecting annuity providers. ACLI noted that the area of concern regards the interpretation that the plan fiduciary is expected to evaluate the financial status of the insurance company with ongoing liability for the financial security of the annuity provider. ACLI proposed an alternative that would provide a safe harbor where the plan fiduciary can rely on the insurance regulatory structure to analyze financial condition, and provide the public with assurance of the safety, of the insurance carrier. The testimony reviewed what state insurance regulators do to evaluate and monitor insurance carriers, and the value that brings.

The testimony supported illustrating the account balances as projected lifetime income on participant statements, and expressed appreciation that DOL is working on this issue.

ACLI noted that the issues surrounding the requirement for spousal consent on plan distributions complicate administration and requested that DOL issue guidance to ease the burdens.

**Kelli Hueler
President and CEO, Hueler Companies**

Kelli Hueler testified about a lifetime income product that was launched in 2004 called the Income Solutions® annuity program.® Under this program an individual can connect with a sponsoring organization to purchase an annuity after competitive bidding process which is as favorable as a group annuity. Ms. Hueler noted that the company offers the only nonexclusive, independent, institutional annuity platform available to plans. She noted that the platform has been adopted by some of the industry's largest plan administrators and plan sponsors, as well as

key industry associations and fee for service advisors providing thousands of employer-sponsored plans access to the platform. Her testimony addressed five things to think in response to Council questions: (1) participant risks and considerations; (2) sponsor risks and considerations; (3) how to facilitate adoption of retirement income – structural and active guidance; (4) barriers; and (5) competition and transparency.

Ms. Hueler testified that plan sponsors are very concerned about fiduciary risk and that the selection of insurance companies is a major issue for plan sponsors and individuals. She stated that the company uses financial data, including rating agency information, and obtain help from an outside service to screen insurance companies with quarterly updates. She noted that the purchase process is designed to present individuals with fair and unbiased information, to provide answers to questions, and to help e potential buyers understand the product. In addition, she discussed the importance of competitive pricing, transparency and fee disclosure.

Ms. Hueler noted that the information and tools built into the system architecture is “structural guidance” and question answering by a salaried employee of a program, a partner, or of the Hueler Company is “active guidance.” She noted that in her experience the majority of buyers have questions that they want to have answered by a person and that the conversation that takes place is very important to the purchaser. She noted that while structural guidance is very important, it is not enough. Ms. Hueler stated that as part of the structural guidance that suitability reviews were incorporated into the process allowing information on buyers to be provided to purchasers. The reviews show that when people buy annuities, they usually use 20% to 25% of their assets for the purchase.

In her testimony, Ms. Hueler stated that additional barriers to, and support of, annuity purchase are often found in the communication with participants, and may even be related to conflicts of interest. She stated that she and other members of her staff have listened to recorded calls, and in some firms, annuity purchase is presented fairly and encouraged, while in others the participant is directed to another option. According to her experience when people buy annuities, they usually use 20% to 25% of their assets, and many of the purchases are after the participant leaves the plan.

Ms. Hueller noted that the three key participant risks and good reasons for annuitization are (1) investment risk, (2) longevity risk and (3) inflation risk. She further noted that the needs of participants vary by their life stages. In her work Ms. Hueler focuses on people who are transitioning to retirement and who are in retirement and noted that if the investment markets produce poor returns early in retirement that it is often a major issue for retirees.

The question was asked about whether today’s low interest rates make annuities more expensive and Ms. Hueler responded that while prices have increased, annuities still offer a very good value compared to fixed income assets in the marketplace. She noted that yields on all types of fixed income investments have dropped dramatically.

Allison Klausner

General Counsel of Benefits at Honeywell International, testifying on behalf of American Benefits Council (“ABC”)

Ms. Klausner testified regarding the fiduciary barriers, and the disclosure and education needs relating to income replacement or lifetime income products from the perspective of employer or plan sponsor. She stressed that offering employee benefit retirement plans is a voluntary system and any mandates or requirements imposed on employers could be burdensome, causing some employer to cease offering such benefits. Ms. Klausner stated that disclosure and education should be encouraged, not mandated. She noted that if DC plans were required to include an in-plan annuity vehicle as an investment fund such inclusion could create administrative complexities, challenging fiduciary obligations, and new and increased plan fees and costs which would more likely than not be borne by the plan participants.

Ms. Klausner stated that the most significant obstacle plan sponsors face providing an income stream for life is fiduciary concerns. The selection of an annuity provider is a source of significant potential liability and in the absence of employee demand for income replacement products it is hard for companies to incur this potential liability. She recommended that to overcome this obstacle, plan sponsors need clear, simple, fiduciary guidance allowing them to make lifetime income options available to plan participants without potential fiduciary liabilities. She stated that the DOL’s Interpretive Bulletin 95-1 does not apply to the selection of an annuity contract for distributions from a DC plan. She recommended that DOL provide a safe harbor that would address the fiduciary liability concerns that plan sponsors currently have if they inform participants about the availability of the annuity platform for roll-overs IRAs, without any endorsement that would imply fiduciary responsibility. She also recommended that Interpretive Bulletin 96-1 be used as a template for developing rules and guidance with regard to distribution education.

She noted that an employer’s approach to total retirement security is based on many factors including: types of plans offered - DC vs. DB; employee demographics; benchmark comparisons to other companies; portability of benefits; changes in participant circumstances; and changes in business operations.

During the Q&A session, Ms. Klausner was asked about inquiries from retirees or near-retirees about their concerns about distributions. She indicated that participants and retirees were more concerned about the taxation of the distributions or the fact that they have to take a distribution at a certain age. She indicated that she was not aware of anyone at her company that has asked about an investment in an annuity option regarding their DC plan.

Kevin T. Hanney
Direct of Portfolio Investments
United Technologies Corporation Pension Investments Group (“UTC”).

Kevin Hanney provided testimony regarding obstacles facing plan sponsors when offering income replacement products. He noted that UTC provided several retirement plans, including a cash balance DB plan and a traditional DB plan. He stated that UTC embarked on developing a new retirement option, within the DC plan, that is designed specifically for the purpose of replacing income in retirement called the “lifetime income strategy.” This product, he noted, was designed to improve the probability of a participant reaching his or her desired level of retirement income. Mr. Hanney shared with the Council that out of 100,000 participants, approximately 5,000 have investment elections in the lifetime income strategy to-date, with additional calls expressing interest and seeking more specific information on the product.

In summary, the lifetime income strategy is a target date investment strategy using an investment advisor to determine where it makes sense to begin purchasing units in group annuity contracts. It operates similarly to an individual variable annuity but with several providers. Mr. Hanney shared with the Council how important it was to understand that in providing any income replacement solution that there needs to be a considerable effort on the part of the employer and professionals to evaluate the solution and determine whether it is appropriate for the plan participants. He noted that this is a significant obstacle for many plan sponsors, especially smaller companies. To help further alternatives options, Mr. Hanney recommended the following actions that could be taken:

- Establish clear but flexible guidance from all regulatory agencies to promote the development and adoption of income replacement solutions.
- Recognize that overly proscriptive standards will stymie innovation, reduce competition, and fail to meet the needs of a broad range of plans and participants.
- Update language in existing guidance to reflect recent product developments and innovations so fiduciaries can understand what is covered by existing guidance and safe harbor provisions.
- Define the characteristics of a qualified retirement income alternative with sufficient breadth so as to capture not only the products and services which function as the direct source of retirement income, but also to address their integration within the retirement vehicles and portfolio construction strategies.

Mr. Hanney stated that the regulatory agencies are in a position to provide the necessary level of competence to plan fiduciaries by issuing and clearly communicating, a process-focused standard of care for the evaluation, selection, and monitoring of income replacement solutions and service providers. He noted that a safe harbor to shield fiduciaries from costly lawsuits and potential liability would be appropriate.

During the Q&A session, Mr. Hanney was asked how the concerns over the safe harbor were overcome with the implementation of the lifetime income strategy. He stated that UTC believed that even if its interpretation of the safe harbor was optimistic, that the standard of care under ERISA in general was something it would seek to exceed.

Cynthia Mallett
Vice President for Industry Strategies & Public Policy, Corporate Benefit Funding
Division, MetLife

Ms. Cynthia Mallett discussed MetLife's recently released study entitled "Perspectives of Plan Sponsors and Recordkeepers for Qualified Plans." The study, which surveyed 12 of the largest DC plan record keepers and 215 plan sponsors offering DB plans and/or DC plans, was intended to assist plan sponsors and record keepers to identify plan participants' retirement needs and to devise retirement income solutions under their DC plans. She noted the importance of this focus because of the continued shift from DB to DC pension plans, and the need for DC plans to evolve from supplemental savings plans to primary, or in some cases the only, employer - provided retirement plans for many workers. Ms. Mallett noted that a shift in focus from solely assets accumulation to include income distribution is critical for participants to best determine their retirement income needs, gain access the tools and solutions to generate guaranteed income in retirement.

The study explored the dynamics of the plan sponsor and record keeper relationship and the efforts being made to provide participants with the necessary education, tools, awareness and solutions, as well as identifying the perceived obstacles to providing retirement income options under DC plans. Under the study, 81% of plan sponsors reported that plan participants have the ability to make retirement income projections. But only 28% of plan sponsors stated that projections were automatically shown to participants when they viewed their account balances on-line, and only thirteen of the plan sponsors include retirement income projections on participant statements.

Ms. Mallett stated that changing the plan's ultimate focus and goal is the driver for determining whether retirement savings and retirement income are primary goals of plan participants. Under the study, 91% of plan sponsors concluded that accumulation of retirement savings is the primary focus of their DC plans, and only 9% of plan sponsors stated that retirement income and distribution is a primary focus. Ms. Mallett stated that learning from the study more participants would like a focus on lifetime income but is offered by few plan sponsors. She noted that record keepers and plan sponsors agreed that retirement income will be the biggest issue under DC plans in the years ahead.

In her testimony, Ms. Mallett noted that the current legal standards do not provide plan sponsors sufficient protection to offer retirement income solutions, and noted they are concerned about their ERISA fiduciary obligations in this area. She testified that safe harbors would be both welcomed and helpful, and suggested building on the existing participant disclosure rules. In addition, she proposed expanding IB 96-1 to clarify what information could be provided to educate participants without being characterized as fiduciary advice.

Ms. Mallett also suggested that DOL take a fresh look at the fiduciary duties surrounding the selection of annuity providers who offer lifetime income products to plan participants. She noted that 79% of the plan sponsors surveyed stated that fiduciary liability concerns discourage them from more widespread offering of income annuities within their DC plans.

Richard Pretty
Senior Managing Director and Product Actuary
TIAA-CREF

Mr. Pretty testified about the importance of lifetime annuities and lifetime guarantees as DB plans have become less available to employees. He noted that the insurance industry is responding with the development of an array of products. Mr. Pretty stated that the options can be generally categorized as withdrawal income or lifetime income options, with each having advantages and disadvantages. He noted that the disadvantage of the withdrawal income option is the risk that you may outlive the underlying assets, and the disadvantage of the traditional lifetime annuity is relinquishing control of and access to the assets. This, he noted, could be important if there is an emergency for additional funds.

Mr. Pretty stated that a compromise option, the Guaranteed Living Withdrawal Benefit, assures a lifetime benefit with access to cash, but noted that the lifetime benefit is reduced if you access the cash. He noted that a person with a retirement fund of 50% equity and 50% fixed income who retires with a plan to withdraw 5% a year has a greater than 20% chance of depleting the fund within 30 years. As Mr. Pretty stated, this needs to be a concern especially with the realization that for a married couple age 65 there is a 25% to 40% likelihood that one of them will live 30 years.

He stated that for a participant thinking of retirement, the following considerations are relevant: longevity risk, inflation risk, rising health care cost risk, investment return risk (particularly losses in the first years of retirement) and cognitive risk (the risk of mental inability to deal with finances in later life). He pointed out that lifetime income annuities address a number of these considerations. He noted that for the plan sponsor, there is a concern that providing an in-plan lifetime income option has a fiduciary obligation with respect to the selection of the institution of the provider of the lifetime income. He stated that a safe harbor provided by regulation would provide comfort to plan sponsors who would like to provide lifetime income options. He noted that another fiduciary concern for plan sponsors is assessing the costs of products they offer.

Mr. Pretty testified that TIAA-CREF offers a variety of online and individual interactive educational programs. He noted that changing the focus from accumulation of savings to retirement income (distribution) is critical to achieving better retirement outcomes. He spoke about the TIAA-CREF approach, noting that they start early with employees. He said the company has them set income goals and then project with them whether they are on track to meet those goals (using red, green and yellow lights to illustrate it). He noted that TIAA-CREF is seeing 25% to 40% of retirees choosing lifetime income options for at least a portion of their savings because of their educational programs. He pointed out that online projection tools are useful as an educational tool but should not be one dimensional. The tools should provide an array of assumptions that the employee can use in making the projections so they can see a range of outcomes.

The sooner an individual starts contributing to what ultimately would be their long-term guaranteed income the better that outcome will be as opposed to delaying the projection and decision making until they reach retirement.

Srinivas Reddy
Senior Vice President, Institutional Income
Prudential Retirement

Mr. Reddy testified that in-plan retirement income options have been slow to keep pace without-of- plan options, but that they are increasing. He noted that plan sponsors face the following challenges with respect to offering lifetime income solutions: assessing insurers' long term viability, comparing new and innovative products, educating workers and dealing with product portability.

He stated that on the viability issue, sponsors should be able to rely on state regulators who deal with this issue. Further, he said that DOL should clarify the regulations, and in a way that will not stifle innovation. With respect to comparing new products, he noted that sponsor anxiety will be alleviated over time as they become more familiar with the offerings. With regard to education, he stated that sponsors are concerned with the regulatory distinction of education vs. advice . He requested that DOL amend or supplement IB 96-1 to address this concern.

Through guidance, Mr. Reddy said DOL should condition participants to think in terms of future income, not just accumulation. The guidance, he stated, should encourage the use of lifetime income calculators. He shared that in Prudential's experience, when workers use calculators, they increase their deferral rates. With respect to portability, he stated that most providers can accommodate the transfer of lifetime income products from the 401(k) to the IRA and that work is progressing in providing for portability from one plan to another. He said that Prudential found that participants who opt for retirement income solutions defer 38% more income, were better diversified and were 2.5 time more likely to stay the course during volatile investment periods.

He stated that showing employees, through use of a calculator, how much lifetime income their rate of savings will generate results in an increased amount of savings. He spoke about one competitor having a mechanism to show persons in a certain profession what portion of their income their peers are saving. This, he notes, also generates greater savings.

He noted that lack of participant focus on the importance of lifetime income for retirement leads to lack of diversity in investment, low deferral rates and loss aversion. He cited the results of a study conducted by Prudential, where 40% of participants over 50 years of age were invested 100% in equities or 100% in fixed income. These problems lead to delayed retirement, higher health care costs for employers, and a decreased ability for plan sponsors to predict and plan for retirements.

He said when it comes to actually putting money in a guaranteed income product, Prudential recommends to participants to start doing it ten years before their targeted retirement, noting that in a ten-year horizon they have not seen a market that has performed worse than what the cost of the guarantee would be. Prudential believes that is not a risk participants can afford to take within ten years.

He said that the industry is a far way off from having capacity issues in handling participant shift to lifetime retiree income products. He noted that there are insurance products with regard to possible adverse longevity risks; that DOL can help in education efforts through clear regulations on the status of annuities and education vs. investment advice. Moreover, education efforts should encourage the use of projection tools and teach participants how to annuitize.

Richard Bailey, FSA, MAAA
VALIC

Mr. Bailey stated that retirement income is much more challenging for individuals than asset accumulation because of the unknowns: how long they will live and what their expenses will be. He noted that there are three choices available to the individual: manage their distributions, purchase annuities, or some combination of both. With the option of managing their distributions, he stated that there is no guarantee they will not outlive their income. An option, he noted, could be to allocate income distributions based on a projection of a very long life, but that would reduce the amount of yearly income and still not guarantee that the individual will not outlive their money, even when meeting investment targets.

He spoke with respect to the guaranteed income side, noting that there are products that allow persons to use conservative assumptions and accept a lower initial income amount, thereby increasing the chances that they will be protected against later inflation. He spoke of the option that permits the participant to choose investing a part of his/ her assets in an annuity and manage the remaining funds.

He noted that longevity products involve a pooling of the longevity risk. He said that one reason DB plans have declined is that employees undervalue them in the same way that participants undervalue and underutilize lifetime income products. He said that the complexity of longevity products, the under-appreciation of longevity risk, and the difficulty in determining how much retirement income will be needed, are factors that contribute to this undervaluation.

He pointed out that there's a significant gap in the income options available and utilized in DC plans compared with those more available in the marketplace. He noted that there is an even wider gap between participants' knowledge on managing income in retirement and what most experts advise them to learn. He stated that too often, employees contribute to their 401(k) only up to the amount their employer is matching because they do not know how much they should save to provide adequate income replacement in retirement. He noted that individuals need tools to help them determine how much they should save.

Mr. Bailey stated if individuals have a guaranteed income, where they were actually giving up all liquidity and all of the cash values currently, that there is certainly greater leverage in purchasing something earlier because, in a case of 10,000 people there is an acceptance of some greater risk of dying too soon in terms of greater leverage against the risk of living too long. He noted that with respect to the possibility of adverse longevity experience, life insurers are in a much better position to handle this.

Jason Scott
Managing Director
Financial Engines Retiree Research Center.

Dr. Scott stated that Financial Engines, through its services and its partners, assists 8 million 401(k) plan participants, generally in large plans, with investing and planning for retirement. He stated that Financial Engines devises portfolios and manages portfolios for 600,000 participants with the median participant client having a \$40,000 account balance. The company recently introduced a retirement income service called “Income Plus” that offers flexible, stable payouts that participants can choose to make last for life.

In his testimony, Dr. Scott made the following observations:

First, that DC plans have a big role to play in retirement income due to their lower costs, general access to service providers, and efficacy. He defined efficacy to include, the success of plans, through defaults, in increasing participation rates, saving rates and investment allocation diversification. He supported the use of defaults on the retirement income (decumulation) front.

Second, that workable lifetime income solutions must meet the needs of both participants and plan sponsors. He observed that 401(k) plans are built around choice, both in terms of sponsors offering a plan and participants choosing to use it. With respect to retirement income, he noted that his research indicates that participants value:

- Income payments that are stable over time with no major declines (Safety)
- Income payments that can last for life (Safety)
- Protection from poor market performance before and during retirement (Safety)
- No irrevocable commitments. Ability to reverse any decision (Control / Flexibility)
- Access and control of assets at all times (Control / Flexibility)

Maintaining access and control, he noted, is especially important to retirees and stated that for lifetime income solutions to be successful in DC plans that participants must be allowed to maintain control of their retirement assets while still receiving income.

He noted that plan sponsors often take the following positions with respect to retirement income solutions:

- They must be operationally easy to add to the plan without complex and costly changes and added measures.
- They must be easily removable to accommodate changing needs of the participants and to avoid the locked-in feeling.
- There must be clear application of fiduciary responsibilities and avoidance of legal or regulatory uncertainty.
- Sponsors want to avoid conflicts of interest.
- Sponsors do not want high or hidden costs.

Third, Dr. Scott stated that current regulations should consider participant flexibility to retain control. In addition, he noted that participants can improve their financial situation by delaying their receipt of Social Security benefits and using their 401(k) accounts to provide income in the interim.

Stephen Sexauer
Chief Investment Officer, AGI Solutions

Stephen Sexauer provided testimony on behalf of Allianz Global Investors Solutions. He framed his testimony to answer the overarching question: how can we create almost guaranteed income in a largely Defined Contribution (DC) world to replace the Defined Benefit (DB) plan.

Mr. Sexauer stated that he did not see DC plans as the solution to retirement income that many people believed them to be because: 1) the coverage rate for DB plans never covered the entire population and 2) some DB plans were poorly managed, leaving participants with inadequate protection or minimal benefits paid through the PBGC, noting that the failure of some plans has been catastrophic for those not covered by Social Security. He also noted that the dominant source of retirement income for the majority of Americans will be Social Security benefits and that both DB and DC plans are important secondary supplements.

He stated that DC plans leave participants with the difficult task of figuring out how to turn account balances into lifetime income. He suggested that participants need professional calculations to translate their account balances into a steady stream of income. He pointed out that there is no risk-free solution to retirement income. He noted that it helps to point out the decisions involved in managing the risks in order to get retirees to where they need to be. However, longevity pooling is necessary and provides large gains and up to 30% fewer assets needed to fund a given level of retirement income.

Mr. Sexauer noted that the five dominant risks are not saving enough; longevity risk or outliving savings; investment risk including inflation risk; counterparty risk; and liquidity risk. He suggested that people need professional advice in figuring out how much to save, access to longevity pooling, inflation-protected income and clarity about the costs of various options.

Mr. Sexauer made the following recommendations: (1) Continuously promote increased savings with good participant choice and incentive; (2) Develop a public benchmark to permit for default asset allocations and risks profile, (3) Create a lifetime income safe harbor; (4) Provide sufficient public and employer-provided participant education to help them make informed choices; (5) Provide clear guidance in rules and regulatory form to allow plan sponsor to more widely embrace offering lifetime income options to their participants.

Julie Mix McPeak

Commissioner of Insurance for the State of Tennessee; Chair of the National Association of Insurance Commissioners Life Insurance and Annuities Committee

Commissioner McPeak provided testimony on behalf of the National Association of Insurance Commissioners (NAIC)'s Life Insurance and Annuities (A) Committee regarding the state insurance regulators' oversight of the life insurance and annuities industry. She stated that life insurance companies are subject to stringent laws and regulations, and that state insurance regulators have broad authorities to identify and address issues before they threaten an insurer's solvency or otherwise pose an issue for the protection of policyholder interests. Her testimony focused on the insurance regulation's financial solvency framework, insurance company receivership and market conduct regulation regarding consumer protections. Ms. McPeak stated that it is the responsibility of state insurance regulators to protect policyholders and to ensure a healthy competitive market for insurance products. She also indicated that NAIC is in the process of forming a working group to consider the soundness of the annuity providers as part of DOL's safe harbor provisions.

Insurance Regulation's Financial Solvency Framework: Under this structure, issuers are required to be licensed in their state of domicile and in all other states where their products and services are sold. A critical component of the regulatory system is detailed and transparent reporting and disclosure requirements. Another important aspect is the emphasis that is place on capital standards. The NAIC risk-based capital (RBC) system serves as a safety net for insurers, is uniform among states, and provides regulatory authority for timely action. State insurance investment laws limit on the amount and type of investments insurers can make in an effort to limit the company's risk exposure.

Ms. McPeak also described the minimum valuation and reserve requirements for life insurance policies and contracts which are defined in the "Standard Valuation Law" and adopted by all 50 states. She noted that life insurers are also subject to periodic stress tests involving an annual cash flow testing exercise designed to test the company's resilience to specific interest rate scenarios, as well as other financial requirements.

Insurance Company Receivership: Ms. McPeak discussed the receivership process and the ramifications to policyholders. She stated that in the case of an insolvent insurer the receivership laws of the state give policyholders priority over most claimants, with state guaranty funds to serve as a backstop if the insured does not have sufficient funds.

Market Conduct Regulation: Ms. McPeak stated that regulators also have broad authorities to police the conduct of insurers and agents. To further this goal, she noted that the NAIC took specific steps to ensure the suitability of the annuity for the consumer, citing a few examples.

During the Q&A session, Ms. McPeak was asked about the state guaranty fund and how it applies to a particular contract. She indicated that the consumer (under both individual and group annuities) is required to purchase an annuity in the state where they reside – residency governs the guaranty for the annuity. She noted that products are approved on a state-by-state basis. Also, she noted that guaranty coverage varies by state and type of product but can range from \$100,000 to \$500,000.

She also said that the states have a prohibition on discussing the existence of a Guaranty Association at the insurance agent or company level at the time an insurance transaction is being conducted. After the purchase is made, some states allow notification while other states mandate notification of the existence of a Guaranty Association. She stated that it has long been the historical perspective of insurance regulators that insurance consumers should not have to rely on the existence of a Guaranty Association when deciding to purchase an insurance product, including an annuity. Rather, she noted, the industry would rather consumers look at other factors such as the rating associations of insurance companies and the financial stability of a company. When questioned about appropriate standard for a safe harbor for plan sponsors and fiduciaries with respect to selecting providers of annuity, Ms. McPeak noted that they should not rely solely on the fact that a company is licensed in a state, but should also take into account the significant oversight by State and some of the factors used in this process.