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Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Room N-5655  
U.S. Department of Labor  
200 Constitution Avenue, NW  
Washington, D.C. 20210

**Attention: Lifetime Income RFI**  
**75 Fed. Reg. 5253 (February 2, 2010)**  
**RIN 1210-AB33**

Dear Sir and Madam:

AARP appreciates the opportunity to comment on the Request for Information of the Departments of Labor (DOL or Labor) and Treasury (Treasury) on the issue of lifetime income for retirement plan participants and beneficiaries.<sup>1</sup>

As the largest nonprofit, nonpartisan organization representing the interests of Americans age 50 and older and their families, a major priority for AARP is to assist Americans in accumulating and effectively managing adequate retirement assets to supplement Social Security. Nearly half of our members are employed, full or part-time, with many of those employers providing retirement plans. Many defined benefit plans now offer numerous distribution options, other than the default joint and survivor option, at retirement, requiring a decision that was not contemplated when ERISA and REA were enacted. Moreover, the shift away from defined pension plans to defined contribution plans places significant responsibility on individuals to make appropriate decisions concerning their contributions, their investments and how they will manage their money once they retire so that they will have adequate income to fund their retirement years. The recent financial turmoil and scandals underscore the importance of these decisions.

In order to make the review of AARP's responses easier, we have grouped our questions and answers in the same manner that the RFI has grouped its questions. Finally, AARP has initiated a survey and other research on individuals' views about annuities and other lifetime income products. We expect to complete a report on the survey results in late spring and will be happy to share our

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<sup>1</sup> AARP will use the term participants and beneficiaries interchangeably; the terms are meant to be inclusive.

findings with the Departments of Labor and Treasury at that time. Based on the survey's findings, we may also supplement the answers that we are providing today.

AARP appreciates the opportunity to present its views on the Department's proposed regulation concerning investment advice. Please do not hesitate to contact me at 202/434-3750

Sincerely,



David Certner  
Legislative Counsel and Legislative Policy Director  
Government Relations and Advocacy

cc: Alan D. Lebowitz, Deputy Assistant Secretary  
Robert Doyle, Director, Office of Regulations and Interpretations  
Stephanie L. Ward, Office of Regulations and Interpretations  
Luisa Grillo-Chope, Office of Regulations and Interpretations  
Joseph Piacentini, Chief Economist and Director of the Office of Policy and Research  
Timothy D. Hauser, Associate Solicitor  
William Taylor, Regulation Counsel, Plan Benefits Security Division

Peter J. Marks, Associate Chief Counsel  
Office of Division Counsel  
Tax Exempt & Government Entities

May 3, 2010

**AARP Response to  
Request for Information on Lifetime Income  
75 Fed. Reg. 5253 (February 2, 2010)  
RIN 1210-AB33**

AARP welcomes the interest of the Departments of Labor and Treasury in the issue of lifetime income for retirement plan beneficiaries and participants. Today, only about 21 percent of workers have defined benefit (DB) pension coverage whereas 43 percent have defined contribution (DC) plan coverage.<sup>2</sup> Only a small fraction of DC plans offer an annuity or other lifetime income option. Moreover, while traditional DB plans provide lifetime streams of income, many DB plan sponsors today also offer lump-sum benefits and many retirees are opting for them.<sup>3</sup> Younger workers are more likely than older workers to have only a DC plan, and the number of workers retiring with substantial retirement account balances received as a lump-sum is growing. It is not clear how, or how well, beneficiaries will manage those assets throughout decades of retirement.

A combination of research, education, a larger and more efficient market for lifetime income products, and new policies will be needed to ensure the economic security of future retirees. Options for increasing the share of retirement wealth that is annuitized should be carefully assessed, and must consider appropriateness for a variety of individuals, costs, and individual preferences and behavior. AARP is currently conducting a survey as well as a controlled experiment to assess individual perceptions and attitudes about lifetime income options. The survey will ask about the plans of older workers and recent retirees for managing income in retirement, and about the distribution options offered to plan participants, the planned or actual choice of distribution option, and the interest in alternative options. The survey will also examine whether and how information about streams of income influences attitudes about lifetime income options. Preliminary results will be available later this spring. The experiment will aim to further our understanding of how biases affect perceptions about annuities and, in particular, examine whether default settings and the use of deferred annuities, such as longevity insurance, are feasible strategies to improve annuity take-up rates. AARP will be pleased to provide copies of the research reports to both agencies as soon as they are finalized. Results will also be posted to [www.aarp.org/ppi](http://www.aarp.org/ppi).

Low-cost annuitization options should be readily available and promoted, and employer plans should provide an annuity option.<sup>4</sup> Policy innovations should include measures to reduce

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<sup>2</sup> Sandy Mackenzie and Ke Bin Wu, *Employer-Provided Pensions: Less to Count On*, (AARP Public Policy Institute, October 2009), Table A.5.

<sup>3</sup> See for example Alan P. Blosston, *Payment Options Under Retirement Plans*, (U.S. Department of Labor, Bureau of Labor Statistics, April 2003) for a discussion of these trends. Accessed at <http://www.bls.gov/opub/cwc/cm20030409ar01p1.htm>. See also n. 17, *infra*.

<sup>4</sup> Most of AARP's comments herein reference fixed annuities. A variable annuity can be a useful adjunct to other forms of retirement income, but it requires more financial sophistication or the annuitant because of greater volatility and risk than a fixed annuity.

unnecessary barriers to employer and employee participation in lifetime income solutions, and ensure that consumers are informed and protected from unsuitable products including those with excessive fees and expenses. Increasing the size of the market for annuities would reduce their cost.

However, it is important to recognize that annuities or other lifetime income products are not for every retiree. Annuities are particularly ill-suited for those who have small account balances, those whose wealth in retirement is already substantially annuitized, and those with more limited life expectancy. It is therefore necessary to maintain individual choice, and to ensure that workers and retirees are well educated about the suitability of lifetime income options to their particular circumstances.

Concerns about the importance of a secure stream of retirement income highlight the critical importance of Social Security. Social Security is the largest source of annuitized wealth for most workers. Social Security is the principal source of family income for nearly half of older Americans, and twenty-three percent of those aged 65 and over live in families that depend on Social Security benefits for 90 percent or more of their income.<sup>5</sup> Social Security keeps more than a third of older Americans out of poverty<sup>6</sup> and provides a steady source of income that keeps pace with inflation and never runs out, no matter how long one lives. Social Security is the cornerstone of retirement security for virtually all Americans and must be preserved and strengthened. Moreover, delayed claiming of Social Security is a cost-effective way to increase the share of annuitized wealth. Nonetheless, Social Security was never intended to be the only source of retirement income and it is important to explore ways to increase annuitized wealth, particularly for workers in the middle of the income range.

We encourage the Departments of Labor and Treasury to keep the issue of lifetime income for retirement plan beneficiaries and participants in the forefront of policy development and public discussion.

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<sup>5</sup> Selena Caldera, *Social Security: Who's Counting On It?* (AARP Public Policy Institute, April 2010), Table 1.

<sup>6</sup> *Ibid*, Figure 4.

## GENERAL

### **1. From the standpoint of plan participants, what are the advantages and disadvantages for participants of receiving some or all of their benefits in the form of lifetime payments?**

#### *1. Advantages:*

Retirees who choose to take a lump-sum distribution from their plan face a number of challenges. First, they must manage their assets to last their lifetime. This is not an easy task for anyone, and certainly not for those retirees who are not highly literate financially. For those households for whom DC balances represent their primary retirement savings vehicle, their decisions as to the investment and use of their DC balances will seriously affect overall retirement wellbeing. Second, uncertainty about longevity in retirement (this is referred to as longevity risk) further complicates the difficult task of asset management. If retirees live longer than planned, they may end up with insufficient resources to finance their remaining years. Alternatively, they may die prematurely, leaving a larger than expected estate or having foregone consumption that could have made them better off.

The great advantage of lifetime income products is that they provide longevity insurance, by guaranteeing payments for life. By taking some or all benefits as lifetime income, participants will not outlive their resources or be forced to significantly reduce their consumption in their final years because they lived longer than planned.

Because annuities and other lifetime income products pool risks across individuals with different life expectancies, they are able to offer a higher rate of return (assuming the annuitant remains alive) than conventional fixed income instruments. This means that annuities enable higher consumption than otherwise for those who live longer than average. Lifetime income products purchased through employer plans can be particularly beneficial to women. Employer plans must use a single pricing structure that does not differentiate by the life expectancy of the annuitant. As a result, since women live longer than men, they face more favorable pricing on lifetime income products purchased through employer plans.

Another advantage, albeit not one unique to lifetime income products, is that the guarantee of monthly payments for life reduces the need to actively manage one's assets in retirement, which can be quite daunting for some individuals. A 2007 AARP/American Council of Life Insurers (ACLI) survey found that 55% of surveyed participants were not very confident that they would be able to manage their savings and investments to last the rest of their or their spouse's life. In particular, women were less confident than men about being able to manage their savings and investments to last the rest of their life.

Lifetime income arrangements can also reduce transactions costs because once the lifetime income arrangement is made, payments are regularly provided. Having a monthly payment that requires little to no effort to manage each month to meet their retirement income needs would make some individuals better off.

### *Disadvantages:*

Some individuals may be sufficiently annuitized through other sources and it may be prudent for them not to annuitize their DC balance if they need to retain assets to finance uninsurable risk (e.g.: out-of-pocket medical and long-term care expenses) or other contingencies. In addition, some households may wish to leave assets to their heirs and may not want to completely annuitize their assets. According to a 2007 AARP/ACLI survey, 22% of respondents thought it was very important to preserve an estate for their heirs and 40% thought it was somewhat important.

We note some examples of groups of individuals for whom additional annuitization through private annuities may be unnecessary. Individuals may be sufficiently annuitized if the annuity income they receive from Social Security replaces a high percent of their former earnings. These are more likely to be individuals from lower- and medium-income households, for whom Social Security benefits provide replacement rates in the range of between 41 and 55% of lifetime average earnings.<sup>7</sup> Potentially, even retirees with high-income and low SS replacement rates may be sufficiently annuitized if they also receive additional annuity income through an employer-sponsored defined-benefit (DB) plan. Moreover, married persons may have access to annuity income through their spouses in addition to their own sources of annuity income.

Finally, it would be unwise to annuitize all or part of plan balances if the participant is in poor health or otherwise has good grounds for believing that his/her life expectancy is limited.

**2. Currently the vast majority of individuals who have the option of receiving a lump-sum distribution or ad hoc periodic payments from their retirement plan or IRA choose to do so and do not select a lifetime income option. What explains the low usage rate of lifetime income arrangements? Is it the result of a market failure or other factors (e.g.: cost, complexity of products, adverse selection, poor decision-making by consumers, desire for flexibility to respond to unexpected financial needs, counterparty risk of seller insolvency, etc)? Are there steps that the Agencies could or should take to overcome at least some of the concerns that keep plan participants from requesting or electing lifetime income?**

2. The research on why individuals do not buy lifetime income products—even when these products offer real benefits—spans over 25 years. The evidence suggests a number of (now) obvious reasons. As noted in our response to Question 1, these include a preference for liquidity—that is, a desire to hold assets to leave to family members when they die and/or to self-insure against uninsurable contingencies. Moreover, nearly all workers already receive annuity income through Social Security. The annuity income from Social Security represents a sufficient share of retirement wealth for many and, given the preference for liquidity, additional annuitization through the purchase of lifetime income may not be necessary. These reasons imply that 100% annuitization of the retirement nest egg will not be optimal, even if annuitizing part of it is.

Research and anecdotal evidence suggest, however, that liquidity and annuitized pension income alone cannot completely account for the limited take-up of lifetime income arrangements. Other reasons for the low take-up rates include the perceived risk of the annuity provider's insolvency,

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<sup>7</sup> Social Security Administration, *2009 Social Security/SSI/Medicare Information*, May 14, 2009, accessed at <http://www.socialsecurity.gov/legislation/2009%20factsheet.pdf>.

fear of loss of control, perception of poor value for money, unappealing terminology to describe lifetime income products, and the prevalence of the lump-sum as the default setting in DC plans.

Research to date does not allow us to gauge the relative importance of each of these factors in inhibiting demand for annuities. We have learned, however, that describing lifetime income products as a consumption-enhancing product (Brown, et al., 2009) might improve their appeal, as might changing the default option from lump-sum to lifetime income arrangements in DC plans (Gazzale and Walker, 2009). At the very least, denominating retirement plan benefits as lifetime income, in addition to lump-sum, might be a relatively inexpensive policy change that could have some bearing on choice.

More research in this area is certainly warranted. As noted in the preamble, AARP is currently conducting research to further evaluate whether default settings would influence the selection of lifetime income products. AARP's research will also focus on the relative appeal of deferred annuities, such as longevity insurance, compared to immediate annuities. The larger payouts associated with longevity insurance and the tendency to think of money in nominal rather than real terms may make these products more appealing to consumers.

In addition, AARP's research will evaluate the extent to which control over use of funds is salient in lifetime income selection. A finding that control is important would furnish an additional rationale for partial annuity options, which gives participants control over their remaining assets. The lack of flexibility to convert part rather than all of one's plan balance to lifetime income could certainly explain low take-up rates, as most plans require all or nothing choices. Admittedly, even without the in-plan partial option, participants could still annuitize some of their plan balance by withdrawing a lump-sum and purchasing a lifetime income product through the individual market. Few do, however, perhaps because of the inefficiency and additional costs in the individual market.

Lessons could also be learned from understanding the difference in take-up rates of lifetime income arrangements between public retirement systems and private DB plans. Most participants in public retirement systems take the default lifetime income option. The difference in annuity take-up rates may reflect differences in nature of employment in the two sectors (for instance, civil servants have longer tenure, making traditional plans more attractive); a perception that the public retirement systems are more securely funded; despite the state-level guarantee provided to annuity and other insurance policy holders, and less choice between benefit options in the public than in the private sector. Anecdotal evidence indicates that concerns over seller insolvency, heightened in recent years by media coverage of failing pension plans, may be driving participants away from lifetime income arrangements in spite of the protection offered by the Pension Benefits Guaranty Corporation (PBGC). Better participant education and knowledge of the PBGC's safety net could impact the move away from lifetime income selection in DB plans.

Those DC participants who choose the annuity option are entitled to fears about provider insolvency, however, since equivalent protections do not exist for lifetime income products through DC plans. A potential new role for government agencies might be to create or provide a similar insurance protection for lifetime income products. An arrangement similar to the Federal Deposit Insurance Corporation (FDIC), which insures deposits in banks, could be envisioned for lifetime income products. A well publicized government seal of protection might generate consumer confidence in these products, sufficient to raise take-up rates. In addition, more research needs to be done to evaluate the adequacy of state guaranty funds to meet the needs of a large-scale

insurance company's insolvency, applicable suitability standards, and the disclosure requirements. It would be a huge step backwards if participants and fiduciaries started embracing these products and something like the Executive Life debacle occurred.

**3. What types of lifetime income are currently available to participants directly from plans (in-plan options), such as payments from trust assets held under a defined benefit plan and annual payments from insurance contracts under a defined contribution or defined benefit plan?**

3. Defined benefit plans must offer a lifetime annuity option; an increasing number of plans offer a lump-sum distribution option as well. DB plan participants who are married must be offered an annuity with a joint and survivor benefit. Married beneficiaries who choose a single-life annuity or a lump-sum distribution rather than a joint and survivor annuity must obtain spousal consent. Over time, the share of plans permitting a choice has increased substantially, and with it the share of plan participants choosing a lump sum. Inflation indexed pensions are extremely uncommon in the private sector, but indexation or ad hoc arrangements to provide inflation insurance are normally a part of state and local government pensions.

Most defined contribution plans do not offer an annuity option, and the option is unpopular among members of DC plans that do offer it. A survey conducted by Hewitt Associates in 2009 found that only 15 percent of the plans surveyed offered an annuity option, and only 6 percent of plan members that could avail themselves of this option did so.<sup>8</sup> Annuities provided by smaller defined benefit and defined contribution plans might be purchased by the sponsor from an insurance company, although medium and larger plans tend to assume longevity risk themselves.

**4. To what extent are the lifetime income options referred in question 3 provided at retirement or other termination of employment as opposed to being offered incrementally during the accumulation phase, as contributions are made? How are such incremental or accumulating annuity arrangements structured?**

4. By far the most common means of providing retirement income is the exercise of permitted options at retirement. The in-service annuity is still rare. One form of the in-service annuity uses the 401(k) plan as a platform. Each contribution or perhaps a batch of contributions is converted into a deferred annuity as it is made. This avoids investment risk, because the 401(k) plan is never substantially invested in equities or bonds. It also entails gradual annuitization, rather than annuitization in one or several installments near the end of working life. This mitigates interest rate risk, because annuitization does not take place in a single year or period of a few years at career's end, but continuously over the period of plan membership.<sup>9</sup>

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<sup>8</sup> Hewitt Associates, 2009 *Trends and Experience in 401(k) Plans*.

<sup>9</sup> See Sandy Mackenzie, *Hybrids and Other Alternatives to Traditional Pensions*. (AARP Public Policy Institute, April 2010).

**8. What are the advantages and disadvantages for participants of selecting lifetime income payments through a plan (in-plan option) as opposed to outside a plan (e.g.: after a distribution or rollover)?**

8. A plan can offer two broad in-plan options for selecting lifetime income payments. One option is to offer lifetime income products as a distribution option at retirement. A second option is to offer an in-service lifetime income product.

One very clear advantage of an in-plan lifetime income product over one that is purchased in the individual market is the ease of purchasing the product. In an in-plan arrangement, the participant simply selects the annuity option when filing paperwork to take distributions. In addition, the plan fiduciaries have performed the initial vetting of the products. An additional advantage of an in-service product is that interest rate risk is managed, as noted in our response to Question 4.

Outside a plan, purchasing a lifetime income product through the individual market involves several steps. First, the participant needs to withdraw funds from their DC plan. Second, the participant needs to shop around for a lifetime income provider and choose among a variety of different lifetime income products and associated options that are sold with these products. Finally, the participant must choose. Many may find the process too daunting, involving too many steps and complicated choices, and may choose not to purchase an annuity. Others may be less aware of existing products in the market and may not even know lifetime income products are available to them, and settle for more simple products as a result. A further issue arises with the tax treatment of funds withdrawn from a plan and used to buy a non-qualified insurance product, because tax is no longer deferred. (On this point, see our response to Question 28, below.)

Another advantage of purchasing in-plan is the ERISA protection for spouses. (See our response to Question 27 below.) An annuity product selected through a plan must pay a joint and survivor annuity, unless the spouse signs a waiver to allow payments as a single-life annuity. This affords valuable protection for women, who tend to earn only 80 cents to the dollar men earn and also live longer than men (20.1 years at 65 vs. 17.9 years at 65 for men).<sup>10</sup>

A third advantage is pricing. In-plan lifetime income products may be offered at more favorable prices than those sold in the individual market because (1) the pool of annuitants may be larger and (2) the insurer has more information about the annuitant pool in a group market than in the individual market. In addition, in-plan annuities are generally stripped of a significant portion of the sales loads that are typical in the individual annuity marketplace. The plan sponsor usually has greater power to negotiate directly with the insurance company, keeping transaction costs lower.

However, there are some advantages to buying a lifetime income product outside the plan. Selection of lifetime income products and options in-plan tends to be more limited than outside the plan. Some participants may want longevity insurance, stronger inflation protection or other features that their plan does not offer. This greater selection may suit individuals with greater

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<sup>10</sup> Data on gender wage differences are from the U.S. Bureau of Labor Statistics, *Highlights of Women's Earnings in 2008*, Report 1017 (U.S. Department of Labor, July 2009) based on median weekly earnings of full-time wage and salary workers. Data on life expectancy are from The Social Security Administration, *The 2009 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds* (Social Security Administration, 2009) for persons attaining age 65 in January 1, 2010.

financial acumen, who may do better customizing their portfolio with a larger selection of products through the individual market. A further advantage of going outside the plan is that choice is not restricted to all or nothing. In these instances, participants who prefer to convert only part, not all, of their assets to lifetime income would prefer the flexibility that the individual market offers.

Finally, there are two unique issues which should be addressed concerning in-plan lifetime income products. One is what happens to these products in the participants' accounts if the participants change jobs and switch plans; can they or will they be required to roll over these products if they change jobs. AARP submits that penalties to the participant or fiduciary should be prohibited. Second, it is unclear what will happen if the fiduciary changes providers; how would mapping be performed and the participant should not pay any penalties for the fiduciary's decision to change providers. Without an adequate resolution of these issues, they may act as barriers to both participants and fiduciaries choosing such products.

**9. What are the advantages and disadvantages from the standpoint of the plan sponsor of providing an in-plan option for lifetime income as opposed to leaving to participants the task of securing a lifetime income vehicle after receiving a plan distribution?**

9. There are two major advantages from the plan sponsor's view point of providing an in-plan option for a lifetime income stream.<sup>11</sup> First, a plan which offers a lifetime income stream is more comprehensive than a plan that does not. All other things being equal, this could be a plus for recruitment, as employees would find an employer whose plan offered the lifetime income benefit option more attractive than an employer whose plan does not. Second, for those employers who believe they have a stake in the long-term well-being of their employees, offering such a benefit entails desirable and positive consequences for employees enjoying a more secure retirement. Employers offering their retirees the prospect of greater financial security in retirement can enhance their public image by doing so.

There are also several disadvantages to offering a lifetime income distribution option. First, and most significantly, the plan sponsor has the fiduciary duty to research the merits and demerits of various providers in the market place. ERISA fiduciary standards require the plan fiduciaries to perform due diligence in the selection and monitoring of a quality annuity product provider and products to incorporate into the retirement plan. Failure to perform the monitoring function will expose the plan administrator to statutory liability for fiduciary breach. Because many plan sponsors may have limited experience dealing with lifetime income products, this lack of information and discomfort with evaluating these kinds of products along with their knowledge of their fiduciary obligations may pose a significant barrier to sponsors adoption of these options. In addition to these fiduciary concerns, the plan may have to field complaints from employees/plan participants who are dissatisfied with either the products or services of the provider the plan administrator has chosen. These administrative burdens may be alleviated to some extent by sub-contracting out plan administration.

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<sup>11</sup> For purposes of this discussion, it is assumed that the plan sponsor is the employer, and that the employer also acts as plan administrator.

**10. How commonly do plan sponsors offer participants the explicit choice of using a portion of their account balances to purchase a lifetime annuity, while leaving the rest in the plan or taking it as a lump-sum distribution or a series of ad hoc distributions? Why do some plan sponsors make this partial annuity option available while others do not? Would expanded offering of such partial annuity options – or particular ways of presenting or framing such choices to participants – be desirable and would this likely make a difference in whether participants select a lifetime annuity option?**

10. There is limited data on the number or share of plan sponsors that allow participants to use only a part of their plan balance to purchase lifetime income. Anecdotally, it appears that most plans require an “all or nothing” choice. However, some plans are more flexible and do allow partial annuitization. These include the Massachusetts Institute of Technology’s supplemental retirement plan, TIAA-CREF, and the Oregon public employee retirement system.

Plan sponsors take on additional administrative responsibilities when they offer lifetime income as a distribution option. Plan sponsors that consider these responsibilities too burdensome would not offer an annuity – whether full or partial, particularly if there appears to be limited demand for such lifetime income options. Nonetheless, 15 percent of DC plans do offer lifetime income as an option. Although the share of these that offer the option of partial annuitization is unknown, the perception is that few do for reasons that are unclear. As noted, AARP is currently fielding a survey to gauge employee interest in partial annuitization options. The survey results will be available soon.

**11. Various “behavioral” strategies for encouraging greater use of lifetime income have been implemented or suggested based on evidence or assumptions concerning common participant behavior patterns and motivations. These strategies have included the use of default or automatic arrangements (similar to automatic enrollment in 401(k) plans) and a focus on other ways in which choices are structured or presented to participants, including efforts to mitigate “all of nothing” choices by offering lifetime income on a partial, gradual, or trial basis and exploring different ways to explain its advantages and disadvantages. To what extent are these or other behavioral strategies being used or viewed as promising means of encouraging more lifetime income? Can or should the 401(k) rules, other plan qualification rules, or ERISA rules be modified, or their application clarified, to facilitate the use of behavioral strategies in this context?**

11. A number of strategies, drawing from the field of behavioral finance, have been successful at modifying savings behavior. Some of these strategies have been suggested for encouraging the selection of lifetime income products in DC plans. None of these strategies have actually been implemented for lifetime income products, to date, however.

AARP is currently engaged in research to test the strength of a number of behavioral biases affecting demand for annuities and the use of policy levers to overcome these biases. In the meanwhile, the experience of behavioral strategies applied at the accumulation stage, and elsewhere, may shed some light on how well these strategies might work at the decumulation stage.

Research into annuities and other lifetime income products shows that a number of diverse elements enter into the decision to choose them, and that this decision is not entirely based on rational decision rules. A single strategy is, therefore, unlikely to be completely successful. It is likely that

strategies that address behavioral biases would have to be combined with strategies that address market failures in order to significantly raise take-up rates and, at the same time, minimize potential harm to the consumer.

For instance, one suggested strategy is to default individuals into a lifetime income product at the time of distribution, in the hopes of mimicking the successful outcomes observed in automatic 401(k) plan enrollment. However, the experience of DB plans, which has a built-in default annuity option, hints at the possibility that the use of defaults at the distribution stage *by itself* may not produce results equivalent to that observed with retirement saving. Similarly, the suggested strategy to denominate assets as a stream of payment (as it is in DB plans) may not result in significantly higher take-up rates if implemented by itself.

Defaults, if implemented, would have to include a strategy that enables individuals to hold some liquidity (for reasons explained above). One approach might be to encourage plan sponsors to move away from the “all or nothing” option and allow the selection of lifetime income products purchased with part (rather than all) of the assets in DC plans. The success of this particular combination of policies would depend in large part on their importance relative to the strength of other biases and influences.

The perception that lifetime income products are bad value appear to weigh heavily on consumers. This could be, in part, because of prior reputation and, in part, because there are no simple comparisons or benchmarks (as there are with financial investments) with which to evaluate value. If the choice is between something known or something unknown with a bad reputation, then the choice is obvious. Although annuities are not actuarially fair (no insurance product can be due to the cost of financial intermediation and administration), many individuals would still benefit from annuitizing their retirement assets because of the risk protection it affords.

The default trial lifetime income proposal gets around some of the impediments to annuitization outlined above. The proposal defaults a portion of assets in retirement accounts into a lifetime income product. The default feature removes much of the complexity of the decision, reframes the way participants view their benefits, and removes endowment bias. Only some assets are defaulted into the trial plan so participants still have access to liquidity. The trial period of 24 months enables individuals to experience annuities and learn about them, as well as time to evaluate the income stream relative to their resource needs. It also buys them time to plan their future retirement needs. Finally, because the proposal is a trial, not a permanent, lifetime income product, participants for whom it is a bad fit would have the option to take the lump-sum after the trial period or to purchase an alternative product. For those who continue with the product after the 24-month period, it converts to permanent lifetime income flow.

Some insurers have expressed interest in developing a trial lifetime income product. Certain design and pricing issues still need to be worked out before this proposal could be implemented, however. Questions include whether joint and survivor should be included during the trial period. Questions also remain about the cost of a cash-out feature with trial lifetime income. The proposal could be combined with other proposals, such as those that recommend laddered (sequential) annuitization to mitigate interest rate risks, when the plan transitions from a trial to a permanent state.

Some of the features of the trial and laddered proposal might conflict with certain ERISA requirements, such as the requirement for joint and survivor annuity and required minimum

distribution rules. Some modifications to these rules may be required if this proposal is implemented.

**12. How should participants determine what portion (if any) of their account balances to annuitize? Should that portion be based on basic or necessary expenses in retirement?**

12. AARP recommends that retirees with considerable savings consider annuitizing a large enough share to cover recurring expenses, to the extent that they are not covered by Social Security or other guaranteed income sources.<sup>12</sup> The decision to annuitize is a very personal one. The right decision depends on the particular circumstances of the potential annuitant. Nonetheless, the share of wealth that should be annuitized at retirement also depends on some objective factors, and must be made taking into account the share of wealth that is already in annuitized form, like Social Security or a traditional pension. In addition, annuitization may not be appropriate for small accounts because the premium may be high for the small amount of annuity received and the annuitant may not have adequate liquidity after the purchase is made.

The share of wealth to be annuitized will depend largely on how much money a retired person wishes to bequeath, and on the predictability of his or her expenditure needs. For example, the more comprehensive a person's health insurance, the more he or she can annuitize without fear of being short of money if and when major illness strikes. The same is true of long-term care. Another determining factor is the extent to which it is possible to borrow against the stream of income that an annuity pays. The greater the amount of money that can be raised using annuities as collateral, the less is the risk that unexpected expenditure needs will cause a liquidity crisis.

The size of the retirement nest egg and the amount of assets relative to income are also important considerations. As noted, it is not cost effective to annuitize small account balances. In this and other situations, it is possible that annuitizing enough wealth to generate income sufficient to cover basic expenditures could leave a retiree with very little non-annuitized wealth. The opposite could also apply: for someone with substantial wealth at retirement, annuitizing only enough to cover basic expenditure needs could entail a lesser degree of annuitization than was desirable. The reliability of a benchmark like basic expenditure will of course depend on how basic expenditure is defined.

**13. Should some form of lifetime income distribution option be required for defined contribution plans (in addition to money purchase pension plans)? If so, should that option be the default distribution option, and should it apply to the entire account balance? To what extent should it apply to the entire account balance? To what extent would such a requirement encourage or discourage plan sponsorship?**

AARP believes that employer-provided plans should give participants the option to take their benefits in the form of an annuity.

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<sup>12</sup> See AARP Money Matters Tip Sheet, "Spending Down Your Assets in Retirement" at [http://assets.aarp.org/www.aarp.org/articles/money/financial\\_pdfs/spend\\_down\\_retirement\\_2009.pdf](http://assets.aarp.org/www.aarp.org/articles/money/financial_pdfs/spend_down_retirement_2009.pdf); and Anthony Webb, *Providing Income for a Lifetime, Bridging the Gap between Academic Research and Practical Advice*, (AARP Public Policy Institute, June 2009).

Requiring sponsors to include a lifetime income distribution would increase administrative costs. We believe that the cost increase would be small, and that the disadvantages of a requirement would likely be outweighed by the advantages of making annuity and other lifetime income options more widely available. However, more data on the extra costs a requirement would entail would be helpful for evaluating the likely impact of a new requirement.

In addition to considering whether to require lifetime income options, policymakers should consider ways to reduce the costs of lifetime income options to both sponsors and beneficiaries, and especially their costs to smaller employers. The Department should provide ample guidance and education to employers and employees about choosing lifetime income options. The Department's work on 401(k) fees starting in 1998 provides a useful structure for issuing guidance on lifetime income stream products. Checklists, general guidance and model forms will be a starting point for fiduciaries in considering such products as potential investment and distribution options for participants. Consumer guidance and educational materials will also be helpful to participants. These can be issued more quickly than formal guidance and regulations, but can still be illustrative of the issues fiduciaries and participants should consider when looking at such products. While formal guidance is needed, we also note that by relying more on these tools and increasing the size and diversity of the risk pool we will also increase familiarity with the products and reduce transactions costs, administrative burden and premiums.

**14. What are the impediments to plan sponsors' including lifetime income options in their plans, e.g., 401(k) or other qualification rules, other federal or state laws, cost, potential liability, concern about counterparty risk, complexity of products, lack of participant demand?**

14. Our responses to questions 9 and 10 state our view as to the perceived impediments to plan sponsors to include lifetime income options in their plans. There may also be some concern about counterparty risk, i.e., the capacity of the obligor on the annuity contract to deliver payments in accordance with the terms of the annuity contract.

**15. What are the advantages and disadvantages of approaches that combine annuities with other products (reverse mortgages, long term care insurance), and how prevalent are these combined products in the marketplace?**

15. Reverse mortgages can be an alternative to annuities as a way to provide economic security to older homeowners who are "house-rich, but cash-poor." A reverse mortgage is a loan that does not need to be repaid until the last borrower dies, sells the home, or permanently moves. Because they are secured entirely by home equity, reverse mortgage underwriting does not require income or credit history checks – making such loans especially attractive for those who would not qualify for other types of loans. Reverse mortgages can be structured as monthly payments to supplement income, as a one-time lump sum, or as a line of credit to be drawn upon as needs arise. When compared to an annuity, a reverse mortgage has more flexibility in how payments are received; indeed, a borrower can switch from monthly payments to a line of credit at any time if a major expense arises. As loans, reverse mortgages generally do not have the consequences for taxes and public benefits that annuities have. Moreover, the vast majority of reverse mortgages are insured by

the federal Home Equity Conversion Mortgage (HECM) insurance program, so they do not have the risk of the annuity insurer going out of business. They are, however, expensive loans with substantial upfront fees.

Some lenders have marketed reverse mortgages to purchase annuities, a practice now forbidden under federal law for reverse mortgages insured by the HECM program. Such transactions add the transaction fees of the annuity to large upfront fees associated with a reverse mortgage to purchase an annuity with few advantages over a regular reverse mortgage with monthly payments. Moreover, the borrower must take out a large sum to purchase the annuity, so compounding interest costs are much higher than the incremental interest on smaller monthly payments. In addition, too many of the annuities sold to older reverse mortgage borrowers have been variable, investment-type annuities more appropriate for younger persons or (worse) deferred payment annuities with terms that can only be described as a scam: e.g., a 15-year deferred annuity sold to an 85-year-old woman. For these reasons, AARP has opposed the use of reverse mortgages to purchase annuities.

The combination of annuities with long-term care insurance is another type of combined product that has attracted some interest from policy researchers and insurers. From an insurance perspective, such a combination would appear to offer economies from the offsetting risks associated with these two products: i.e., longevity risk associated with an annuity is offset by the risks of declining health associated with long-term care insurance. From a consumer's perspective, a single product could insure against a number of risks and may offer some savings. Psychologically, such a combination may assuage the feeling that insurance costs are "wasted" if no claim is made. For example, individuals who have paid for an annuity only to find they have a life-shortening illness a short time later may find it a better deal if they are at least getting a long-term care benefit. Similarly, a person who has no debilitating condition may be less likely to feel that the money for long-term care insurance is "wasted" if they are receiving annuity payments for an extended time.<sup>13</sup>

Despite these apparent advantages, combining annuities and long-term care insurance can have distinct disadvantages as well. To begin with, the potential cost savings are quite modest – estimated by one study at about 5 percent. Often such hybrids make sacrifices on the quality of one or both of the components – annuities with lower monthly payments or lower long-term care benefits. The combination may be difficult for regulators to evaluate and effectively monitor. Perhaps most importantly, combining two inherently complicated financial instruments into one product makes it even more difficult for consumers to understand or to compare to other ways of addressing their needs. Even if these products are good ones, the combination products will tie up a considerable amount of an individual's income and assets so that costs not covered may be more difficult to pay for – e.g., costs for home modifications or a specialized van associated with dealing with a disability. While the combination of annuities and long-term care insurance merits more exploration, AARP urges caution before the federal government should encourage consumers to use such instruments.

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<sup>13</sup> See Marc Freiman, *Can 1 + 1 = 3? A Look at Hybrid Insurance Products with Long-Term Care Insurance*, (AARP Public Policy Institute, May 2007).

**16. Are there differences across demographic groups (for example men vs. women) that should be considered and reflected in any retirement security program? Can adjustments for any differences be made within existing statutory authority?**

16. There are differences in life expectancy between men and women, and between healthy and less healthy workers, high and low income workers and ethnic or racial groups. In single-pricing arrangements, persons with higher than average life expectancy, such as women and healthier workers, stand to gain more from the arrangement than persons with lower than average life expectancy, such as men and less healthy workers. Allowing price to vary by expected life expectancy will improve pricing for the latter group; however, this differentiation also reduces the mortality credits inherent in lifetime income products, which reduces the benefits to the former group of workers.

For instance, differentiating by health, which tends to correlate with income, means less healthy persons, who tend to be lower-income workers, are less likely to be subsidizing the payouts to healthier and, typically, higher-income workers. Differentiating by gender means that female workers, who tend to earn 80 cents for every dollar earned by male workers, would lose some of the subsidy from male workers.

Because existing law holds defined benefit plans to a gender-neutral approach insofar as annuitization is concerned, we think it is necessary to address the matter of whether annuity products purchases within 401(k) plans require gender-neutral annuitization schedules, or if such products may be designed based strictly on pertinent mortality tables.

In the United Kingdom, annuity pricing varies by health status or health behavior. These impaired or enhanced annuities pay higher than normal income for individuals in poorer health, who smoke or are overweight. A similar arrangement in the U.S. that allows lifetime income to vary by health status could make these products relatively more attractive to a larger group of consumers.

## **PARTICIPANT EDUCATION**

**17. What information (e.g. fees, risks etc.) do plan participants need to make informed decisions regarding whether to select lifetime income or other arrangements designed to provide a stream of income after retirement? When and how (i.e. in what form) should it be provided? What information currently is provided to participants, who typically provides it, and how is it provided to them?**

17. Participants need a clear description of the basic properties of any lifetime income arrangement. If the arrangement would take the form of an annuity, all available riders, including any guarantee feature, should be clearly described. Participants should understand the consequences of the absence of a guarantee as well. Although the failure rate in the United States of annuity providers has been extremely low, the process that would apply in the case of failure of a person's insurance company, including guaranty fund coverage, should be clearly explained. The tendency for the real purchasing power of a fixed nominal annuity to decline over time must also be explained. To appreciate the insurance value of an annuity, it would be useful to compare its conditional rate of return—i.e. the rate of return that would be earned if the annuitant lived to some advanced age—with the rate of return of a long-term bond. Because annuities are not well understood, information on them needs to be provided some years before the normal retirement date, and should be provided more than once.

The information that annuity providers now furnish their clients varies depending on the type of annuity, applicable regulations, and the company. This inconsistency can lead to consumer confusion and purchase of the wrong annuity product. Consumers frequently misunderstand or receive inadequate explanations regarding surrender charges applicable to deferred annuities, regardless of whether fixed, indexed, or variable.

Disclosures must be timely, tested, and accurate. To that end, disclosure documents should be given prior to purchase. Disclosure documents should be standardized, and they should be consumer tested prior to their use. Prospectuses required for variable annuities are of little help as a disclosure because they can be cluttered with too much information, which can cause consumer confusion.

**18. Is there a need for guidance, regulatory or otherwise, regarding the extent to which plan assets can be used to pay for providing information to help participants make informed decisions regarding whether to select lifetime income or other arrangements designed to provide a stream of income after retirement, either via an in-plan or out-of plan option?**

18. Guidance, either in regulatory communications, or simply in the form of educational information would be useful and desirable to inform plan sponsors, plan administrators, and plan participants as to the lawfulness and appropriateness of suitable annuity products to round out 401(k) distribution options. Guidance as to the use of plan assets to pay for providing information to help plan participants make informed decisions regarding the use of annuity products in-plan or out-of plan would also be useful. Additional guidance and revision of technical rules as to

minimum required distributions, etc., could be efficacious to promote the appropriate use of stream of income concepts either through in-plan or out-of-plan options.

**19. What specific legal concerns do plan sponsors have about educating participants as to the advantages and disadvantages of lifetime income or other arrangements designed to provide a stream of income after retirement? What actions, regulatory or otherwise, could the Agencies take to address such concerns?**

19. Plan sponsors are concerned about the form and content of their communications to employees, in view of the responsibility plan sponsors and administrators have to communicate benefits information to employees in clear and unambiguous terms. Legal liability for failure to fulfill ERISA's statutory mandate that Summary Plan Descriptions be expressed in language calculated to be understood by the average plan participant very likely influence plan fiduciaries in all of their communications to participants. It would probably be very helpful for DOL and IRS to make a concerted and careful effort to promote use of post-retirement stream of income concepts to plan fiduciaries and to participants. This could be done by means of web postings, circulars, forms, and other educational tools, perhaps even through dispatching a crew of speakers on the subject in settings aimed at all key stakeholders, employers, employees, and professionals who service plans. Clear communications to stakeholders as to form and content of annuity subject matter would furnish both symbolic and substantive endorsement of the life income concept as integral to retirement planning. In addition, model forms and checklists are always helpful to plan sponsors and fiduciaries.

**20. To what extent should plans be encouraged to provide or promote education about the advantages and disadvantages of lifetime annuities or similar lifetime income products, and what guidance would be helpful to accomplish this?**

20. Plan should be strongly encouraged to increase understanding not only of annuities but also the broader context of retirement income management and planning, which tends to be deficient even among generally knowledgeable investors. The point of retirement provides plan sponsor a unique opportunity to engage their workforce (particularly those approaching retirement) on this issue as they begin to contemplate life and more importantly their financial situation after they retire. The key topics of concern include concepts such as:

- Sources of retirement income
- Guaranteed vs. variable streams for retirement income
- Recurring basic expenses (fixed) vs. lifestyle expenses (variable) expenses
- Claiming social security benefits
- Annuitizing assets and the various income products available
- Managing lump sum assets (withdrawal rates, asset allocation)

The concept of annuitization and annuity products should be a part of most people's general financial education. This requires reforms over which federal agencies would have only indirect influence.

Guidance about annuities should begin well before plan members reach retirement age. As our response to Question 17 discusses, it is especially important to make potential annuitants aware of the insurance aspect of the product, to counterbalance the view that the risk of early death makes annuities a bad investment.

## **DISCLOSING THE INCOME STREAM THAT CAN BE PROVIDED FROM AN ACCOUNT BALANCE**

**21. Should an individual benefit statement present the participants' accrued benefits as a lifetime income stream of payments in addition to presenting the benefits as an account balance?**

21. Yes. This simple change to the standard reporting format would serve a very valuable purpose. People have considerable difficulty in converting a stock of assets to a lifetime flow. The conversion should, however, be done at several rates of interest, or three different yield curves. At a minimum, the assumptions underlying the estimated stream of income need to be clearly stated.

**22. If the answer to question 21 is yes, how should a lifetime stream of income be expressed on the benefit statement? For example, should payments be expressed as if they are to begin immediately or at specified retirement ages? Should benefit amounts be projected to a future retirement age based on the assumption of continued contributions? Should lifetime income payments be expressed in the form of monthly or annual payments? Should lifetime income payments of a married participant be expressed as a single-life annuity payable to the participant or a joint and survivor-type annuity, or both?**

22. The income stream should be calculated assuming that it begins at a specified retirement age, based on the current plan balance, and on reasonable assumptions regarding contributions and rates of return between the present date and the date of retirement. The calculation could be derived from a formula supplied by the DOL, or from assumptions made by the plan sponsor, although these should be subject to DOL guidelines. Another possibility is to base the calculation on quoted annuity prices. This method would require that assumptions be made about the relationship between current annuity premiums and premiums as of the year of retirement.

The assumptions underlying the calculation of a lifetime stream of income should be made clear. For example, the calculation might assume that salary in the pre-retirement period is equal to the average salary earned during the current and previous three years. Payments could be expressed in either monthly or annual terms. Finally (and ideally), when the plan participant is married, the benefit statement should include the value of both the single-life and the joint and survivor pensions.

**23. If the answer to question 21 is yes, what actuarial or other assumptions (e.g. mortality, interest, etc.) would be needed in order to state accrued benefits as a lifetime stream of payments?**

23. At a minimum, the calculation of the regular annuity payment requires that assumptions be made about the term structure of interest rates and the mortality rates of retirees. Assumptions about separation and mortality rates of the active workforce are also necessary.

In the case of a deferred or in-service annuity, the same assumptions are necessary, but the projection of interest and mortality rates must now cover a longer period. This extra requirement may pose a problem for the projection of interest rates, because the plan's most distant liabilities may have a duration longer than that of long-term bonds. For deferred and immediate (or near immediate) annuities, a caveat to the effect that the calculations are illustrative is a good idea.

The DOL could recommend the use of the mortality table that PBGC has constructed, and use of this table could be required or regarded as fulfilling a safe harbor. Plans will typically have to hire an actuary even if they take their interest rate and mortality assumptions from a standard source, because the work involved is relatively specialized.

The Federal Thrift Savings Plan (TSP) statement may provide a useful model. However, the TSP information would have to be modified to reflect the cost of annuities purchased in the private sector. For example, if an in-plan annuity is not offered, the annuity calculations should be based on gender-specific actuarial assumptions, consistent with annuity offerings in the individual market.

**24. Should an individual benefit statement include an income replacement ratio (e.g., the percentage of working income an individual would need to maintain his or her pre-retirement standard of living)? If so, what methodology should be used to establish such a ratio, such as pre-retirement and post-retirement inflation assumptions, and what are the impediments for plans to present the ratio in a meaningful way to participants on an individualized basis?**

24. While an income replacement ratio could be a helpful tool, we believe it may be impractical for periodic individual benefit statements to contain a homogenized statement of post-retirement income needs. The diversity of individual and family circumstances, lifestyles, and life philosophies suggest that there are too many variables to permit a clear process for determining the standards that would be necessary ingredients to formulate such a statement. Substantial further research would be needed to create a meaningful targeting tool.

## 401(K) AND OTHER PLAN QUALIFICATION RULES

**25. How do the 401(k) or other plan qualification rules affect defined contribution plan sponsors' and participants' interest in the offering and use of lifetime income? Are there changes to those rules that could or should be made to encourage lifetime income without prejudice to other important policy objectives?**

25. We believe that rules and regulations regarding the timing and amount of required and permissible distributions from 401(k) plans and IRAs of all types should be examined to ascertain if any of them detrimentally impact the selection of an annuity option, if and where available, for partial or full distribution of retirement plan assets.

**27. Should further guidance clarify the application of the qualified joint and survivor annuity rules or other plan qualification rules to arrangements in which deferred in-plan insurance annuities accumulate over time with increasing plan contributions and earnings?**

27. Current protections for spouses of plan participants are stronger in defined benefit plans than in defined contribution plans. Under the Retirement Equity Act of 1984 (REA), beneficiaries of defined benefit plans must obtain written spousal consent to take payment in a form other than a joint-and-survivor annuity.<sup>14</sup> These rules were enacted in order to ensure that both spouses were involved in decisions concerning retirement benefits that had been earned during the marriage and to protect spousal rights to a portion of the benefit in the event of divorce or death. During the hearings of the bills leading up to the passage of the REA, many spouses spoke of the financial hardship after their husband's death.<sup>15</sup>

Such protection for spouses is unavailable in individual retirement accounts and rare in defined contribution plans.<sup>16</sup> Thus, employees can withdraw and use retirement monies in such plans without spousal consent, undercutting marriage as an economic partnership. This is a serious shortcoming in the area of spousal pension protections. AARP believes that these protections need to be strengthened, not reduced.

Moreover, the spousal consent rules certainly have not prevented individuals from taking lump sum distributions from defined benefit plans. For those participating in defined benefit plans, lump-sum distributions are increasingly available.<sup>17</sup> Participants who take a lump sum distribution are not

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<sup>14</sup> ERISA § 205.

<sup>15</sup> Steven Cohen, *Autoenrollment and Annuity: Enabling 401(k) "DB-ATION"*, 5 N.Y.U.J.L. & Bus. 281, n. 180 (Spring 2009). Statistics showed that many women fell into poverty after their husband's death. Retirement Equity Act of 1983, *Hearing Before the Subcomm. on Labor of the Senate Comm. on Labor and Human Resources*, 98th Cong. at 27-29 (Oct. 4, 1983) (statement of Janie Sowards of the Oklahoma Federation of Business and Professional Women's Clubs).

<sup>16</sup> Steven Cohen, *Autoenrollment and Annuity: Enabling 401(k) "DB-ATION"*, 5 N.Y.U.J.L. & Bus. at 318.

<sup>17</sup> See, for example, U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, 2005 BULLETIN* (2007),

receiving the benefit that a joint and survivor annuity provides. By choosing a lump sum distribution, a participant bears both the longevity risk and the post-distribution investment risk. The longevity risk most affects the spouse and has the greatest negative implications.<sup>18</sup>

We urge the Department to ensure that spousal protections are in place for deferred in-plan insurance annuities that accumulate over time with increasing plan contributions and earnings, along with any other retirement income stream product. For example, participants generally receive information describing an account balance and may not realize that a joint and survivor option better protects their spouses. The value of a joint and survivor option should be pointed out in the IRS relative value notice.

Finally, an “in-plan insurance annuity” is merely a ban on at least part of the benefit being in a lump sum. It seems counter-intuitive that a participant should buy insurance with the attendant costs as a plan investment option. An “in-plan insurance annuity” makes even less sense in a defined benefit plan where the plan would be paying the extra cost of the insurance product rather than being self-insured—which is the nature of a defined benefit plan.

**28. How do the required minimum distribution rules affect defined contribution plan sponsors' and participants' interest in the offering and use of lifetime income? Are there changes to those rules that could or should be made to encourage lifetime income without prejudice to other important policy objectives? In particular, how are deferred annuities that begin at an advanced age (sometimes referred to as longevity insurance) affected by these rules? Are there changes to the rules that could or should be considered to encourage such arrangements?**

28. Guidance regarding the tax treatment of deferred annuities (including longevity insurance) and the partial annuitization of retirement accounts is needed. However, to our knowledge, neither plan sponsors nor individuals focus on the RMD rules as a reason not to purchase a lifetime income stream product. Any changes to the RMD rules should be carefully considered, so that the benefits of increasing retirement security outweigh the costs of added complexity, unequal treatment of income from different sources, and revenue losses.

From a tax perspective, a more troublesome issue arising with the use of lifetime income streams for participants are potential constructive receipt issues. Currently, in order not to be immediately taxed on their account balance, individuals who want to annuitize but do not have an in-plan option must roll over any amounts into another tax qualified plan. That is, in order to continue to defer

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[www.bls.gov/ncs/ebs/sp/ebbl0022.pdf](http://www.bls.gov/ncs/ebs/sp/ebbl0022.pdf) and *National Compensation Survey: Employee Benefits in Private Industry in the United States, 2002–2003* (2005), [www.bls.gov/ncs/ebs/sp/ebbl0020.pdf](http://www.bls.gov/ncs/ebs/sp/ebbl0020.pdf). In 2005, fifty two percent of all private industry employees were eligible for a lump-sum distribution. *Id.* A study by researchers at Vanguard found that 27 percent of defined benefit plan participants from two large plans who were eligible for a lump-sum distribution chose to take annuity as the payout option. Gary R. Mottla and Stephan P. Utkus, *Lump Sum or Annuity? An Analysis of Choice in DB Pension Payouts*, VANGUARD CENTER FOR RETIREMENT RESEARCH, Vol. 30, November 2007, <https://institutional.vanguard.com/iam/pdf/CRRLSA.pdf>.

<sup>18</sup> Steven Cohen, *Autoenrollment and Annuitization: Enabling 401(k) “DB-ATION”*, 5 N.Y.U.J.L. & BUS. at 324-25.

taxes, the lifetime income stream product must be held by a custodian of a qualified plan. This rule can be a trap for the unwary. AARP suggests that the Service review these rules to facilitate the use of lifetime income stream products and the equitable treatment of taxpayers who are annuitizing their retirement account nest eggs.

## SELECTION OF ANNUITY PROVIDERS

**30. To what extent do fiduciaries currently use the safe harbor under 29 CFR 2550.404a-4 when selecting annuity providers for the purpose of making benefit distributions?**

**31. To what extent could or should the Department of Labor make changes to the safe harbor under 29 CFR 2550.404a-4 to increase its usage without compromising important participant protections? What are those changes and why should they be made?**

**32. To what extent could or should the safe harbor under 29 CFR 2550.404a-4 be extended beyond distribution annuities to cover other lifetime annuities or similar lifetime income products? To which products should or could the safe harbor be extended?**

30, 31, 32. The regulations governing transactions under section 404 should be consistent. It is imperative that the selection and monitoring of investment options, annuity providers and products and providers of other lifetime income stream products should be subject to the general prudence and loyalty requirements under Section 404.<sup>19</sup> The Department's consistent position as set forth in its amicus briefs should be clarified in both regulations. See AARP Response to Questions 33-34, *infra*. The duties of prudence and loyalty are even more important, if that is possible, at the distribution stage because of the finality of the decision.

AARP suggests expanding the safe harbor in 29 CFR 2550.404a-4 to cover other types of lifetime income stream products. However, fiduciaries need to be aware of potential suitability issues depending on the demographics of the plan participants. Not unlike 401(k) fee disclosures, disclosures to fiduciaries from the providers will be necessary along with participant disclosures. As products become more complicated, disclosures alone may be inadequate to protect participants. For example, for those individual account plans which offer a variable annuity as an investment option, many people do not realize that if they take a lump sum as a distribution at the time of retirement that they have abrogated the rationale for using this as an investment option. Although the Department omitted a detailed list of criteria to be considered as to the insurer's claims paying ability, AARP suggests that the Department reissue this list as part of a checklist for fiduciaries when selecting an annuity or other lifetime income stream product. In addition, the availability and maximum amounts of state guaranty association protection would be useful information to a plan fiduciary. If there should be a carrier insolvency, participants may get cents on the dollar, thereby jeopardizing their economic security. AARP hopes that lessons learned surrounding Executive Life would be heeded.

The checklist should also include criteria which will help fiduciaries to engage in an "objective, thorough and analytical search" among annuity providers, including consideration of the costs, fees and commissions of the annuity products. In addition, guidelines suggesting trigger points at which time "the fiduciary is to periodically refresh its conclusions under the safe harbor" would be helpful. We question, however, whether it makes sense to use DB plan assets to purchase an annuity. (See our response to Question 27 above.)

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<sup>19</sup> Compare 29 CFR 2550.404a-4 with 29 CFR 2550.404c-1.

## ERISA SECTION 404(c)

**33. To what extent are fixed deferred lifetime annuities (i.e., incremental or accumulating annuity arrangements) or similar lifetime income products currently used as investment alternatives under ERISA 404(c) plans? Are they typically used as core investment alternatives (alternatives intended to satisfy the broad range of investments requirement in 29 CFR 2550.404c-1) or non-core investment alternatives? What are the advantages and disadvantages of such products to participants? What information typically is disclosed to the participant, in what form, and when? To what extent could or should the ERISA 404(c) regulation be amended to encourage use of these products?**

**34. To what extent do ERISA 404(c) plans currently provide lifetime income through variable annuity contracts or similar lifetime income products? What are the advantages and disadvantages of such products to participants? What information about the annuity feature typically is disclosed to the participant, in what form, and when? To what extent could or should the ERISA 404(c) regulation be amended to encourage use of these products?**

33, 34. Section 404(c) of ERISA relieves the fiduciary of an individual account plan of liability for losses stemming from the plan's investments, when the plan allows the participants to exercise control over the investment of the assets in their plan accounts, and the plan meets the requirements in the Department of Labor's regulations. Accordingly, Section 404(c) provides an affirmative defense to a claim for breach of fiduciary duty under ERISA.<sup>20</sup>

In a analogous issue concerning the selection and monitoring of investment options in individual account plans, the Fifth Circuit addressed the applicability of ERISA's fiduciary rules to plan provisions requiring ("hard-wiring") the offering and maintaining of specific investments. Where the plan sponsor "hardwired" the investment option into the plan, the Fifth Circuit held that the company had no fiduciary duty to modify the terms of a plan.<sup>21</sup> Consequently, under this rationale, a plan sponsor could require a specific lifetime income stream product, require a specific type of insurance annuity product or prohibit the offering of such products. In all of these examples, there would be no entity which is responsible for the decision to select, not select or monitor an option, even if the fees are expensive and it is an unsuitable product for certain demographic segments of the plan participants. This issue will continue to be even more important as the market place changes, and new products are offered.

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<sup>20</sup> *In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 446 (3d Cir. 1996). In *Hecker v. Deere & Co.*, 556 F.3d 575 (7th Cir. 2009), the Seventh Circuit Court of Appeals ruled that Section 404(c) protects plan fiduciaries from liability for the alleged imprudent selection of mutual funds with excessively high fees. This holding was consistent with other circuit court decisions which also held that in a section 404(c) plan a fiduciary's duty does not include the selection and monitoring of investment options. See *Langbecker v. Electronic Data Sys.*, 476 F.3d 299, 307 (5th Cir. 2007); *Jenkins v. Yaeger*, 444 F.3d 916 (7th Cir. 2006); *In re Unisys Sav. Plan Litig.*, 74 F.3d at 455 (holding that a fiduciary that committed a breach of duty in making an investment decision for a Plan may nevertheless take advantage of the section 404(c) defense). *Contra, DiFelice v. U.S. Airways, Inc.*, 497 F.3d 410, 418 n. 3 (4th Cir. 2007).

<sup>21</sup> *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243 (5th Cir. 2008). *Accord, In re Citigroup ERISA Litig.*, 2009 WL 2762708 (S.D.N.Y. Aug. 31, 2009), *appeal pending* (2d Cir. Dkt No. 09-3804-cv).

Quite simply, this jurisprudence will significantly impact the protections participants could receive concerning the selection and monitoring of annuities and other lifetime income stream products offered in their individual account plans.

The *Deere* court noted that the DOL is free to issue regulations that would more specifically address the section 404(c) issue:

.. . [I]t should go without saying that the Secretary is free to propose and enact new regulations addressed more specifically to the way in which choice of investment options in a plan relates to the safe harbor provision, if she believes that this would be appropriate.<sup>22</sup>

AARP commends the Department for its long held position that when plan fiduciaries have breached their fiduciary duties in the selection and/or monitoring of investment options in individual account plans, participants have not exercised and could not, in fact, exercise effective control over the assets in their accounts. AARP appreciates the Department's strong continuing advocacy on the fact that a plan's hard wiring of investment options into a plan does not necessarily overcome a fiduciary's duty of prudence. These positions must be extended to include the selection and monitoring of annuities and other lifetime income stream products.

However, AARP submits that without these suggested changes in the Department's regulations, ERISA's prudence standards will be seriously undermined.<sup>23</sup> As a consequence, participants will continue to have little protection from a menu of poor investment choices including annuities and other lifetime income stream products. Accordingly, participants may have no recourse for a challenge to a fiduciary's bad selection of investment options. Moreover, the more complicated the choices, the more important the protections -- participants with the least experience should not be forced to make a choice between bad, worse and worst.

Accordingly, AARP urges the Department to clarify its position in regulations on both of these issues. The Section 404(c) regulation must be clarified so that is clear that the scope of a fiduciary's duty includes the selecting and monitoring of investment options including lifetime income stream products. Without this clarification, Section 404(c) will act as a "get out of jail free card" for those fiduciaries who do not take the Department's stance seriously. AARP also strongly supports the synchronization between the disclosure requirements under section 404(c) and those under 404(a). Finally, AARP believes that there may be situations where fiduciaries may have disclosure obligations beyond those explicitly set forth in regulations.

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<sup>22</sup> 569 F.3d 708, 710 (7th Cir. 2009).

<sup>23</sup> ERISA §§ 404(a)(1)(A) & (B) (providing plan fiduciaries shall prudently carry out their duties for the exclusive benefit of participants and beneficiaries).

## QUALIFIED DEFAULT INVESTMENT ALTERNATIVES

**35. To what extent are plans using default investment alternatives that include guarantees or similar lifetime income features ancillary to the investment fund, product or model portfolio, such as a target maturity fund product that contains a guarantee of minimum lifetime income? What are the most common features currently in use? Are there actions, regulatory or otherwise, the Agencies could or should take to encourage use of these lifetime income features in connection with qualified default investment alternatives?**

35. AARP understands the need to consider retirement income solutions during the accumulation phase (via in-service annuities such as those allowed in the QDIA) and also at the point of retirement. Furthermore, AARP does support Agency actions to promote greater adoption of QDIA products with lifetime income protection.

However, prior to actions to promote further adoption, AARP suggest additional review by the Agencies of the use of annuities or other products which guarantee lifetime income as qualified default investment alternatives (QDIA). AARP suggests that a determination of whether such products are appropriate as a QDIA should be based on whether a fiduciary would choose these products as investments for a defined benefit plan.

Moreover, many of these products have high fees. We question whether a product with potential fees including redemption fees, back-end sales loads, reinvestment timing restrictions, market value adjustments, equity "wash" restrictions, and surrender charges are appropriate for a QDIA. Participants may get caught up in a web of fees which will greatly reduce the amount in their account balances, not realizing that they need to keep their accounts in such a product for a period of time longer than expected. We believe that the QDIA should have fee structures that are much simpler, so participants are not plagued by "gotcha" fees.

Perhaps more important is participant's lack of understanding of how these products work. Unfortunately, many participants treat lifetime income stream products like any other investment option. Many participants with annuities or other lifetime income stream products totally cash out of the product when they terminate their employment or participation in the plan. They have paid for the guarantee but then do not take advantage of it. And, these are the participants who have actually chosen this option. Accordingly, this scenario raises two concerns. First, participant disclosures on such products need to be very clear and comprehensive. Second, for those participants who rely on fiduciaries to choose a default investment, disclosures are not going to be enough to protect them.

## **COMMENTS REGARDING ECONOMIC ANALYSIS, REGULATORY FLEXIBILITY ACT, AND PAPERWORK REDUCTION ACT**

### **36. What are the costs and benefits to a plan sponsor of offering lifetime annuities or similar lifetime income products as an in-plan option? Please quantify if possible.**

36. A plan sponsor offering lifetime annuities or similar products is not in the same position as the sponsor of a traditional pension plan. It would not guarantee a premium at retirement for its plan participants who chose these products, unlike a traditional plan where the conversion of contributions into the pension annuity is set by the terms of the plan. The sponsor could buy annuities at group rates from an insurance company, and thus off-load longevity risk to the insurance company. Effectively, the sponsor is a middleman for the decumulation phase of retirement financing. It assumes no risks for its involvement, except perhaps some risk of fiduciary liability.

If the sponsor chose to offer longevity insurance itself, it would have to decide whether it would set the terms in advance, or whether it would simply offer a premium based on the current term structure of interest rates and longevity tables to its employees on the verge of retirement. Doing so would mean that it would be acting like an insurance company and assuming the same risks. In particular, it would be assuming select longevity risk—the risk that its pool of annuitants did not have the same average life expectancy as that assumed for the population—as well as aggregate longevity risk—the risk entailed by uncertain average life expectancies. In addition, it would have to deal with the problem of matching the duration of its assets with its pension liabilities. This do it yourself strategy would only be feasible for large companies, and even for them the risks involved might not make it worthwhile.

The sponsor of a 401(k) plan could contract with an insurance company to offer a variable annuity with a guaranteed minimum or an in-service annuity. As with other annuities, the only obvious risk in this case is the risk of fiduciary liability.

Plan sponsors benefit from offering lifetime income products to the extent that their employees appreciate the benefits they are getting. It is uncertain what share of the older population would perceive annuities favorably, although there is reason to believe that that share is growing.

### **37. Are there unique costs to small plans that impede their ability to offer lifetime annuities or similar lifetime income products as an in-plan option to their participants? What special consideration, if any, is needed for these small entities?**

37. Offering such products requires an increased investment in legal advice, because the plan becomes more complex when these options are added. These and any related administrative expenses are basically lump sum; they do not increase with the size of the plan or its sponsor. Consequently, they impose a burden on the small sponsor. A further consideration for small plan sponsors is that—absent a larger pooling arrangement—they may not be able to negotiate premiums as low as those of larger plans, and self insurance will not be an option.

**38. Would making a lifetime annuity or other lifetime income product the default form of benefit payment have an impact on employee contribution rates? If so, in which direction and why?**

38. As long as employees understand that they ultimately choose whether or not to use the lifetime income option, adding this option and making it the default should not reduce contribution rates and might eventually increase contributions.

Information about the costs and benefits of the lifetime income and other distribution options, and the opt-out feature, should be clearly described to participants and provided at critical points, such as when employees first join the firm, when they become eligible to participate in the retirement plan, when they first enroll in the plan, and at the time of distribution. In addition, the annuity default should only be used for account balances over a certain size, and partial annuitization options should be made available for those with larger accounts.