



Written Testimony Submitted to the

U.S. Senate Special Committee on Aging

on

The Retirement Challenge: Making Savings Last a Lifetime

Wednesday, June 16, 2010

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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 their employers providing retirement plans. Over the last few decades, however, several trends have made achieving and maintaining an adequate income in retirement more challenging than ever before.

First and foremost, many employers have moved away from providing defined benefit (DB) pension plans to their employees and increasingly offer only defined contribution (DC) plans, such as 401(k) plans. Participation in 401(k) plans is voluntary and these plans transfer investment, longevity, inflation, and interest rate risks entirely to the individual. Today, only about 17 percent of workers have DB pension coverage on their current job compared to 41 percent who have DC plan coverage.

Traditional DB plans have historically provided lifetime streams of income, while only a small fraction of DC plans offer an annuity or other lifetime income option. Moreover, many DB plan sponsors today offer lump-sum benefits and many retirees are opting for them. Younger workers are more likely than older workers to have only a DC plan, and the number of workers retiring and receiving their retirement account balances as a lump-sum is growing. It is not clear how, or how well, beneficiaries will manage those assets throughout decades of retirement.

The shift away from DB plans to DC 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.

Perhaps in response to these trends, there is good reason to believe, however, that interest in annuities and other guaranteed income products will grow. Even middle class Americans who have diligently contributed to their 401(k) plans and IRAs for most of their working lives will find that they have accumulated significant balances in their accounts by retirement. Annuitization of at least a part of this balance may become an increasingly attractive option to them. A new survey by AARP suggests that workers nearing retirement are quite interested in lifetime income products – at least in theory. Nearly a third of older workers who have an annuity option in their DC plan say they plan to annuitize all or part of their plan balance. About half of older workers in DC plans who are not offered an annuity would like to have this option. In addition, many older workers say that they are interested in innovations such as partial annuitization, trial annuitization or in-service annuities. These findings suggest that if options for obtaining lifetime income were more flexible and readily available, interest and take-up would grow.

At the same time, 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, those who need liquidity for substantial immediate expenses, 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.

AARP has long been concerned about the ability of our members to accumulate the resources they need to maintain an adequate standard of living throughout their retirement years. Similarly, AARP is also concerned that -- unlike Social Security benefits -- many Americans will outlive the retirement assets they have accumulated due to the combined effects of longer life expectancies and the overly optimistic assumptions many individuals make when spending down these assets. Effectively managing this decumulation phase of retirement can be especially complicated, but it is essential for the long term economic security of millions of American workers who can no longer count on the guaranteed lifetime income stream once provided by workplace DB pension plans.

AARP would therefore like to thank to Chairman Kohl and Ranking Member Corker for holding this important hearing. We appreciate the opportunity to present our views on the issues surrounding lifetime income and look forward to continuing to work with the Committee to improve our existing retirement system.

The Move from Defined Benefit to Defined Contribution

One quite striking feature of the U.S. employer-provided pension is the constancy of its rate of coverage of the workforce: at any given time over the past three decades, about one in two workers have either been covered by an employer-provided plan or contributed to an IRA. As is by now well known, this uniformity of coverage masks a disconcertingly large slide in the coverage of the traditional pension plan. As of 2007, only about 17

percent of workers were covered by a traditional DB plan at their current job.¹ In contrast, 41 percent were covered by a DC plan.

Both reduced demand on the part of workers and reduced supply on the part of employers have been working to reduce the role of the traditional pension. The employer's willingness to offer a traditional DB pension may have been eroded by many factors, including plan cost, changes in accounting standards, and the negative impact of market volatility on the plan sponsor's balance sheet. Some experts have pointed to the so-called perfect financial storm of 2000-2002, experienced again during the recent financial crisis, when plan balance sheets were assailed by declining interest rates and falling securities prices. The enhanced funding standards adopted in the Pension Protection Act of 2006 have also increased the immediate cost burden of DB plans.

On the demand side, greater mobility and the lack of portability has made DB plans more unattractive for the average worker, given the trend to shorter average employment tenure. Confidence of plan participants in the on-going solvency of plan sponsors has probably also eroded, notwithstanding the backstop insurance that the Pension Benefit Guaranty Corporation (PBGC) provides. A desire to maintain control of one's assets, a preference for liquidity, and excessive discounting of future income and needs further increase the attractiveness of pensions that offer a lump sum benefit. In total, the forces acting to diminish the role of the traditional pension will not be easy to reverse.²

¹ See Sandy Mackenzie and Ke Bin Wu. 2009. *Employer-provided pensions: Less to Count On*. AARP Public Policy Institute.

² See George A. (Sandy) Mackenzie. 2010 forthcoming. *The Decline of the Traditional Pension—a Comparative Analysis of Threats to Retirement Security* (Cambridge University Press) for a thorough treatment of these issues.

The Shift from Annuitized to Lump-Sum Distributions

The same forces that are behind the DB-DC shift also lie behind the increasing frequency of lump-sum distributions. The share of traditional plans offering a lump-sum option has increased in part because plan sponsors shed longevity risk and pension costs by increasing the take-up of lump-sum distributions by plan members. As for DC plans, although more of their participants may be interested in the annuity option than had been previously thought, the lump sum option is still the overwhelming choice.³ Inevitably, these same forces have increased the number of workers opting for a lump sum.

In addition to the popularity of the lump sum option among DC plan participants, DC plan sponsors may be reluctant to offer an annuity as an in-plan option because of the added fiduciary responsibility this option raises. In particular, the Employee Retirement Income Security Act (ERISA) fiduciary standards require the plan fiduciaries to perform due diligence in selecting and monitoring an 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.

In addition to these fiduciary concerns, the plan sponsor may have to field complaints from employees/plan participants who are dissatisfied with the products or services of the provider the plan administrator has chosen.

³ An AARP survey of the distribution choices made by workers and retirees with pension plans found that there was definite interest in the annuity option. Specifically, it found that about 31 percent of workers and 25 percent of retirees with DC plans that offered one or more options other than lump sum withdrawal were planning to select or had already selected the annuity option. See Kathi Brown et al. 2010. *Annuities and Other Lifetime Income Products: Their Current and Future Role in Retirement Security*. AARP Public Policy Institute, Factsheet 189 (May).

The Hazards of Excessive Reliance on Lump-Sum Distributions

Retirees who choose to take a lump-sum distribution rather than an annuity from their plan must manage their assets to last their lifetime. Even if individual retirement life spans were predictable, this would not be an easy task for retirees who lack financial sophistication. Uncertainty about longevity in retirement—longevity risk—further complicates the task of asset management. If retirees live longer than planned, they may end up in extreme poverty or destitute. Alternatively, they may die prematurely, leaving a larger than expected estate or having foregone consumption that could have made them better off.⁴

The great advantage of lifetime income products is that by guaranteeing income for life, they provide longevity insurance. 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. Annuities and other lifetime income products can work most effectively by pooling mortality risk across individuals with differing life expectancies and paying only while the retiree remains alive.

Lifetime income products purchased through employer plans can be particularly beneficial to women. Employer plans, in determining the benefit, may not differentiate by the life expectancy of the annuitant. As a result, since women live longer than men, they

⁴ For example, one simulation shows that a retiree who withdraws a constant amount equal to 5 percent of their real initial account balance beginning at age 65 faces a 25 percent chance of exhausting the account balance by age 90, even though the average balance remaining at that age would exceed half the initial balance. See Sandy Mackenzie. 2010. *Hybrids and Other Alternatives to the Traditional Pension*. AARP Public Policy Institute, Research Report 2010-04.

face more favorable pricing on lifetime income products purchased through employer plans.

Another advantage, albeit not one unique to lifetime income products, is that guaranteed monthly payments for life reduce the need for asset management, which some retirees may find quite daunting. 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 finances to last the rest of their or their spouse's life. In particular, women were less confident in this respect than men.

Lifetime income arrangements can also reduce transaction costs for both plan sponsor and participant because once the lifetime income arrangement is made, payments are regularly provided. A monthly payment that requires minimal management to meet their retirement income needs could make many individuals better off.

Improving DC Plans

The number of workers retiring with significant retirement account balances received as a lump-sum is growing. Many of them would benefit from an annuity or other lifetime income option to protect them from investment and longevity risk. Employer plans should provide a lifetime income option, and could be assisted in doing so by education and guidance in selecting plan options.

S. 2832 – *The Lifetime Income Disclosure Act.* One clear improvement to DC plans would be to increase employees' understanding of the stream of income that their account balances will provide. AARP has therefore endorsed S. 2832, the Lifetime Income

Disclosure Act. This legislation would provide individuals with a better understanding of the lifetime value of their 401(k) plan assets by including in a yearly benefit statement a conversion of their total accrued benefits into a monthly dollar amount as if they had opted to receive a lifetime annuity. This information would provide the longer term outlook 401(k) participants need to get a more accurate picture of the lifetime value of their plan and help them make better decisions about how to wisely manage their retirement assets. It may also provide them with an incentive to save more.

ERISA's Fiduciary Responsibilities and Annuities in 401(k) Plans. ERISA requires that a 401(k) plan fiduciary act as a well-informed, prudent expert would when making decisions that affect the plan's investments or expenses. Obligated to act in the best interest of the participants, fiduciaries must independently investigate the merits of any proposed investment, including annuity products that may be on the plan's menu of investment options. They need to understand annuity product features, fees charged, and the merits of the product relative to other similar offerings in the marketplace. Fiduciaries who neglect these duties can be held accountable if they cause the plan to lose money or the investments fail like in the case of Executive Life.

In order to alleviate many concerns that plan sponsors and plan fiduciaries have about selection and monitoring of annuity providers and products, it may be well to consider the implementation through statutory enactment or agency regulation of a safe harbor for plans and their fiduciaries in respect of these issues. It should probably be taken as presumptively correct that variable annuities (as presently marketed) are

generally unfavorable products for inclusion within qualified retirement plans. Therefore, the points that follow are intended to refer to fixed annuity product selection issues.

A safe harbor provision might consist of something as minimalist as a recitation of prescribed standards or criteria for annuity products and/or providers, compliance with which would suffice *per se* to insulate a plan fiduciary from further scrutiny or accountability with respect to selection of the product or provider. At the other extreme, it is conceivable that one or more governmental agencies, such as the Department of Labor, Treasury, etc., could devise and maintain a list of approved annuity providers and products to 401(k) plans based upon established criteria or experience. There are probably other approaches that could be taken to credential annuity products and providers as suitable for use within 401(k) retirement plans.

Addressing 401(k) fiduciary concerns related to provider and product selection by establishing an accessible and rational safe harbor could help encourage the inclusion in plans of annuity options.

Other Options. While we have not solved the retirement savings accumulation problem by any means, we have made substantial progress through auto-enrollment, auto-escalation and qualified default investment account options. These successes offer useful lessons, but designing default options for the spend-down phase presents some unique challenges. There is little risk of saving too much, but there is risk associated with tying up too much of one's nest egg in an annuity. Lifetime income options probably need to be more customized than accumulation options need to be.

To this point, providing partial annuitization options is key, and experience with the Thrift Savings Plan (TSP) and elsewhere suggests that partial options increase take-up of annuities. Trial annuities are also promising, and may be useful in helping new retirees create “a paycheck budget” without locking into a decision too soon.

Two relatively new financial products endow 401(k) plans with some of the features of a traditional pension. The first grafts a variable annuity onto the 401(k) plan with a guarantee. The plan invests a member’s account balance in a diversified portfolio from which he or she can draw once retired. The instrument provides a minimum income guarantee (in nominal, not in real terms) in the form of a specified percentage value, like 5%, of some measure of the plan’s value to date. If withdrawals exceed this value, the guarantee benefit is reduced. The guarantee applies for life, but is financed by an earmarked fee, and not by mortality risk pooling. The guaranteed rate of return the plan can offer is not as a result particularly high. Given our above concerns about variable annuities, these products should be carefully analyzed and reviewed by the fiduciary and, ideally, the participant.

The second product is the in-service annuity, which annuitizes contributions to 401(k) plans as they occur. The conversion of contributions into a deferred annuity as they occur minimizes investment risk, and the continuous nature of conversions reduces the risk of an excessively high premium, which may occur when annuitization is effected through one or two purchases near retirement. Too little is known about this product to say anything definitive about the role it might play in financial security, which will depend on the cost of financial intermediation and the ability to hedge liabilities of long maturity.

Consumer Protection Considerations

As annuities or other lifetime income products are not appropriate for every retiree, 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. Barriers to employer offerings and employee adoption of lifetime income solutions should be reduced; but, at the same time, consumer protections must be preserved and strengthened.

Insurer Solvency. One of the obstacles to annuitizing retirement income through private insurers has been the perception, exacerbated in the recent financial climate, that the insurer could become insolvent and unable to make the required payments. Thus even though an employer or employee chooses a financially secure company when buying the annuity, it is possible that the company's financial condition could change over the decades as the stream of income pays out. Unlike ERISA plans and banks, the solvency of insurers and the guaranty funds that make payments in the event of insurer insolvency are regulated by the 50 states and the District of Columbia, not the federal government. Although this system has worked relatively well in the past, provisions vary across states and the funds do not have federal government backing, unlike the PBGC or Federal Deposit Insurance Corporation (FDIC).⁵

Although each insurer is primarily regulated by one state, all states have similar laws and requirements that are designed to require companies to provide an adequate

⁵ It is also important to note that AIG's state regulated insurance subsidiaries did not cause AIG's problems; an unregulated holding company subsidiary put the company at risk and gave rise to the federal bailout. However, the AIG case does illustrate that the sound regulation of insurance products depends ultimately on the regulation of the financial system as a whole.

margin of safety for the risks they insure. State insurance regulators require companies to use conservative accounting principles and to meet risk-based capital and reserve requirements specifically designed for the types of policies they cover. Regulators monitor insurer compliance through quarterly financial reporting, analysis, and periodic examination. In addition, the National Association of Insurance Commissioners (“NAIC”), an organization of all the state insurance commissioners, has formed the NAIC Financial Analysis Working Group, which works with states to help oversee any nationally significant financially troubled insurer. The NAIC also examines and accredits states that achieve a required level of solvency regulation; at this time all 50 states and the District of Columbia are accredited.

Because of this increased oversight, it is rare for even an insolvent insurer to lack significant assets that may be used to pay policyholders who have priority over other unsecured creditors under insurance insolvency law. In addition, all states have set up state guaranty associations to cover the shortfall in payments by an insolvent insurer and to pay claims in a timely manner while the insurer’s estate is being settled. The guaranty associations are not prefunded, but may call on insurers in the same line of insurance, such as life insurance, to pay a small percentage, usually 2%, of their premiums in that state into the state guaranty fund to cover payments due to an insolvent insurer’s policyholders. Guaranty associations also have other sources of income and the ability to borrow against future payments. They have generally made timely payments to beneficiaries. However, the amount guaranteed varies from state to state. Most states cover only the \$100,000 present value of the annuity contract, although some states cover substantially more and the NAIC has recommended that all states raise the coverage cap

for annuities to \$250,000. There is also great uncertainty as to whether this system could handle a number of large life insurers becoming insolvent at the same time.

ERISA and Preemption of Consumer Remedies in 401(K) In-Plan Annuity

Purchases. In connection with the prospect of annuities being offered as options for investment of 401(k) contributions, it is advisable to examine the implications for consumer protection surrounding the relationship between the annuity issuer and the plan participant who chooses to direct his/her funds to an annuity.

For plans that offer in-plan annuity purchases, generally we may presume that the annuity products offered would be pursuant to a group plan. In the setting of a group provider to plan participants, ERISA has historically constrained the remedies available to the plan participant who has grievances with respect to the group provider's performance or product. For example, a requirement of the participant's exhaustion of internal plan claim procedures is typical. This requirement generally gives the plan the right to assert control over the claims process in the event of disputes. Further limiting recourse for plan participants who challenge the acts or omissions of plan group providers is the frequency of lodging discretion in the plan to make determinations concerning the merits of the participant's challenge. This practice tends to create a dispute scenario that forces disputes between annuity issuer and plan participant to play out on a field that is not level. These issues are generally addressed in the context of ERISA preemption, in particular the preemption of state law remedies.

Attention must be given to the advisability of preserving the full panoply of legal remedies that would ordinarily be available to purchasers of annuity products outside of a

plan (i.e., unconstrained by ERISA's general scheme in the context of pensions, health care claims and disability income benefit claims). Generally speaking, this could be accomplished by disavowing ERISA's claims provisions as the exclusive remedies available to plan participants who purchase an annuity within a plan. Instead, state law consumer remedies could co-exist along side of ERISA's remedial scheme, although it would be well to rule out the internal plan claims process as a requirement for challenges.

As for plans that have no in-plan annuity purchase options, participants in those plans who wish to purchase annuity products would have to take a plan distribution and roll the distribution into an annuity purchase. Presumably, state remedies available to consumers in ordinary arms-length transactions would be available. It may still be advisable to clarify in statutory language that ERISA presents no limitations of state remedies in such circumstances.

Conclusion

A combination of efforts will be needed to ensure the economic security of future retirees. In the lifetime income sphere, these include: further research, participant and sponsor education, and new public policies to promote a larger and more efficient market for lifetime income products. These policies could reduce unnecessary barriers to employer and employee participation in lifetime income solutions, increase the efficiency of annuity markets by such means as the facilitation of group sales, and ensure that consumers are informed and protected from unsuitable products, including those with excessive fees and expenses.

Concerns about the importance of a secure stream of retirement income highlight the critical importance of Social Security, which is the largest source of annuitized wealth for most workers. Social Security is the principal source of family income for about half of older Americans, and roughly one quarter of those aged 65 or over live in families that depend on Social Security benefits for 90 percent or more of their income.

Social Security keeps more than a third of older Americans out of poverty 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 one's Social Security benefit is a cost-effective way to increase the share of a retiree's 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 or guaranteed sources of income, particularly for workers in the middle of the income range.