

## Special Report

### Pensions

#### Lawmakers, Industry Focus on Using Annuities to Enhance Retirement Security

NEW YORK--In a bid to encourage individuals to convert at least part of lump sums received from their 401(k) accounts to an annuity providing lifelong income, House Education and Labor Committee Chairman George Miller (D-Calif.) intends to introduce legislation in July or September outlining his vision for comprehensive reform of Internal Revenue Code Section 401(k) retirement savings accounts, a Democratic committee aide has told BNA.

The legislation will likely address many other issues, the aide said June 6. But a chief goal is to articulate Miller's thinking on the annuities issue. Given the scope of the needed reform, Miller does not expect the legislation to be approved during the 110th Congress, the aide said.

The anticipated bill will appear at a time when other federal legislators are also exploring ideas that might encourage 401(k) account holders to annuitize at least part of their retirement savings due to concerns that retired individuals will outlive their retirement savings, especially because retirees are now living longer. Whether investment strategies funded by lump sums are sound has also been highlighted by recent financial market volatility.

While no federal law prohibits individuals from annuitizing their lump sum retirement payments, few retirees actually exchange those payments for a lifelong annuity, pension specialists say. Possible legislative actions to boost annuities include offering tax incentives to individuals electing to annuitize their lump sum retirement payments and mandating that at least a portion of those payments be annuitized, the committee aide said.

But several insurance specialists told BNA there would likely not be significant support for introducing mandates on what is a voluntary contribution system. Any tax-related proposals would likely need to be vetted by the House Ways and Means Committee and the Senate Finance Committee at a time when those committees are acutely aware of a rising national deficit.

#### Congressional Acts Affecting Retirement

Between the end of World War I and the 1970s, most employers offering retirement plans to their employees relied on employer-provided defined benefit plans, which guaranteed lifetime retirement income for employees meeting defined eligibility requirements.

Retirement savings plans were initiated in part because wage controls in the 1920s prompted employers to provide benefits to their employees in ways that did not involve wages, Anne Waidmann, PricewaterhouseCoopers LLP global human resource services practice director, told BNA June 6.

But in the 1970s, Congress acted to change defined benefit plans in part due to the bankruptcies of several large companies, which left workers who relied on their employer's defined benefit plan for retirement with virtually no savings. In 1974, Congress approved the Employee Retirement Income Security Act (Pub. L. No. 93-406), which in part set minimum standards for funding defined benefit plans, required employers to make certain disclosures regarding the plans, and assigned fiduciary responsibilities to entities managing and controlling the plan.

Since ERISA's enactment, Congress has continued to change defined benefit rules in ways that have made the plans more expensive to operate due to liability and administrative requirements, benefit specialists told BNA.

Then, in 1978 Congress approved The Revenue Act of 1978 (Pub. L. No. 95-600), which included Internal Revenue Code Section 401(k), a tax code section entering into force Jan. 1, 1980 that permitted employees to defer tax on saved earnings until the money was distributed during retirement. Plan rules allow employees easier access to information about their accounts as well as greater control over the account's management and investments compared with defined benefit plans.

### **Increasing Burdens on Benefit Plans**

In 2006, Congress approved the Pension Protection Act (Pub. L. No. 109-280), which many pension specialists said encouraged workers to utilize different types of defined contribution plans, such as 401(k) plans, while creating more burden for defined benefit plan sponsors.

One result of these developments has been a steady decline in the use of defined benefit plans since the 1970s in favor of defined contribution plans such as 401(k) accounts; employers are even terminating their defined benefit plans as employees increasingly embrace defined contribution plans.

"We're moving into a 401(k) world," Groom Law Group partner and former Treasury Department Benefits Tax Counsel (Office of the Tax Policy) William Sweetnam told BNA June 2.

While there are several types of defined contribution plans, 401(k) plans are the largest types of plans measured by assets under management, Sweetnam said. Americans have invested \$4.1 trillion in 401(k) and other defined contribution plans, according to written testimony given to the House Ways and Means Committee by Investment Company Institute President and Chief Executive Officer Paul Schott Stevens Oct. 30, 2007.

### **'Wealth Illusion' Persists**

But the move toward defined contribution plans, which make one-time distributions, has necessarily led to public policy concerns regarding the fate of retirees who outlive those lump sum payments.

"There is a lot of discussion of the problem, but not a lot of discussion about solutions. No one solution is gathering a lot of support behind it," American Society of Pension Professionals & Actuaries chief of actuarial issues and retirement policy director Judy Miller told BNA June 6.

While solutions may not be a chief topic of discussion on Capitol Hill, the public policy implications of retirees outliving their savings are nevertheless serious. Retirees not annuitizing at least part of their savings could result in "millions and millions of people ending up living exclusively on Social Security, as has happened in the past," Employee

Benefit Research Institute President and Chief Executive Officer Dallas Salisbury told BNA June 11.

Another possible outcome is retired individuals hoarding their cash for fear of being, one day, totally broke and perhaps needlessly adopting a less comfortable lifestyle than they in reality can afford, Salisbury said.

But many pension specialists said that retirees simply prefer to retain their lump sum payments from 401(k) plans, particularly when they see how much money has accumulated in their retirement plans. "It's hard to say goodbye to a large sum of money," Waidmann said. Fees associated with buying an annuity, which may be viewed as expensive by some individuals, may further discourage retirees from purchasing an annuity, Waidmann said.

### **Reluctance to Annuitize**

The reluctance to part with lump sum payments for a lifelong annuity was illustrated by Salisbury and is attributed to what he labeled as the "wealth illusion." Savings accumulated in a 401(k) plan totaling \$100,000, for example, will typically convert into an annuity paying retirees about \$450 each month for life.

Retirees may view the monthly payment as meager compared with the lump sum amount and elect to retain and invest the \$100,000, which the retiree concludes will result in a more comfortable lifestyle. But the idea that the \$100,000 is worth much more than the guaranteed monthly payment for life may easily be shattered, particularly if retiree investments do not perform well or the retiree lives many years longer than expected, Salisbury said.

A June 4 report on annuitizing lump sum payments prepared by The Retirement Security Project, a project supported by the Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Washington-based Brookings Institution, highlighted the fact that retirees do not know how long they will live, which necessarily leads to financial uncertainty. "Managing assets over an uncertain horizon is complicated, and the stakes are high if one makes a mistake," the report said.

For example, a 65-year-old male retiree can expect to live to 82, on average, but has a 19 percent chance of living to age 90 or beyond, the report said. And a 65-year-old female can expect on average to live to 85, but has a 31 percent chance of living to age 90 or beyond, the study said.

### **Understanding 'Risk of Living Too Long.'**

"There's an educational void. People don't understand the risk of living too long," Salisbury said.

Yet as talk about annuitizing voluntarily contribution plans heats up, Washington, D.C.-based Investment Company Institute data show 75 percent of all retirees already depend on an annuity, their Social Security payments, for the vast majority of their income during retirement.

Indeed, the quartile with the greatest wealth relied on Social Security for 31 percent of its retirement in 2006 but was the only quartile not dependent on Social Security for more than 67 percent of their total retirement income in 2006, the data show.

Springfield, Mass.-based Massachusetts Mutual Life Insurance Co. Senior Vice President (retirement income business) Drew Dickey told BNA June 17 the insurance industry is presently "coming to grips" with the expected shift from defined benefit plans to an environment where more retirees will possess some form of defined contribution plans.

For instance, the insurance industry is beginning to develop new products combining variable annuity products and income annuity products to meet what Dickey said is an imminent necessity for retirees in the financial retirement marketplace.

### **Retirement Security Project**

The Retirement Security Project proposed in its report a plan that would force retirees to at least try annuitizing a part of their defined contribution plan savings for two years. Under the proposal, retirees would receive 24 monthly checks, a process which in part would acclimate recipients to the concept of receiving an annuity.

Retirees could affirmatively elect not to participate in the program. And at the end of the trial period, retirees could elect an alternative distribution option or, if they did nothing, be defaulted into a permanent lifelong income distribution plan, according to the proposal.

"An automatic 'trial' period of monthly income based on a substantial portion of their assets could accustom individuals to the consistency, security, and simplicity of receiving regular monthly payments and help reframe the way they view their retirement resources. The regular income stream (or 'pension check'), rather than the lump sum, may come to be seen as the status quo or presumptive form of benefit," the report said.

The report said plan sponsors could be encouraged to participate in the trial by giving them discretion over some of the plan's structure and implementation. The report said congressional action would be needed for the concept to be enacted. For instance, federal retirement savings distribution rules affecting retirement fund tax treatment would need to be modified and Labor Department rules concerning plan sponsors' fiduciary responsibilities would need to be changed, the report said.

Plan sponsors could choose from "a list of qualified low-cost and low-risk default income options" offered by firms meeting federally specified standards relating to costs and risk exposure. The proposal recommended the federal government create a new agency to supervise lifelong income providers to ensure their safety and soundness, with the entity being funded much the same way the Federal Deposit Insurance Corporation is funded.

The proposal recommended one federal supervisor instead of creating 50 new state agencies to provide the envisioned oversight.

### **Financial Firms Take Cautious Stance**

While the specialists noted the shift among workers away from defined benefit plans and thus to insurance sector products, many financial services firms offering 401(k) and similar plans currently offer products providing lifelong income with the added benefit that their principal may increase due to market conditions. And financial services firm representatives told BNA the intensity and focus of supplying products to the market for that perceived need is increasing.

But few companies were willing to comment on the effect legislation designed to encourage annuitization could have on the financial services sector.

"This is an idea in its early stages. We'll be reviewing [it] with our members," Securities Industry and Financial Markets Association spokeswoman Katrina Cavalli told BNA June 11.

And Boston-based FMR LLC spokeswoman Jennifer Engle told BNA June 17 it was "too early" for FMR business unit Fidelity Investments to comment on specific product solutions given the nascent nature of congressional discussions. But she did say Fidelity currently offers products that include a lifetime annuity component or mutual funds known as

"income replacement funds" that provide retirees with monthly checks for defined periods of time.

Demographic data imply that demand for products ensuring lifelong income will manifest itself in the United States by about 2015, and that financial services firms like insurance companies are now beginning the process of educating the market about taking steps related to their retirement, Dickey said. A chief issue for insurance companies is discovering "how to explain really complicated ideas simply" to consumers, he said.

Indeed, current and expected future demand for more sophisticated retirement solutions that feature principal preservation, extended payout schedules, and even professionally managed mutual funds purchased by relatively young workers saving for retirement is growing, Investment Company Institute Chief Economist Brian Reid told BNA June 17. The institute is a national association of investment entities, including mutual funds, exchange-traded funds, and unit investment trusts.

### **Fixed-Income Products Emerge**

Retirement-related, fixed-income financial products do currently exist, allowing retirees to purchase mutual funds that distribute steady income; when the fund expires the retirees get their investment back. The mutual fund participant is guaranteed a minimum amount, regardless of the mutual fund's performance, and the lump sum could actually grow while under management as well.

Such products are typically more liquid because mutual fund shares can easily be bought and sold, and are typically less costly than a traditional annuity, Director of Structured Products for DWS Scudder Distributors Inc. Jason Hubschman told BNA June 13.

For instance, a mutual fund product offered by DWS Scudder, the U.S. retail brand name of Deutsche Asset Management, an asset management division of Deutsche Bank AG., funded with a \$100,000 investment would generate about \$8,200 in income a year, considerably more than many annuities, Hubschman said.

Deutsche Bank concluded the timing is right for such products in part due to the initial stages of baby boomer retirements, said Hubschman.

But when the funds end, their assets are disbursed, thus not guaranteeing lifelong income, Hubschman said. That disbursement may have tax consequences, and then there are management fees. Additionally, while the amount of principal retirees receive from Deutsche could be more than the \$100,000 initially invested, it is also possible the payment would be as low as \$17,500, he said.

### **Problems With Current Annuities Market**

While many pension specialists said the reasons to encourage workers to annuitize at least part of their savings are sound, they too acknowledged annuities can have their drawbacks. The Retirement Security Project report, for instance, said one reason annuities are currently in low demand is because existing lifetime income products are perceived to be "inflexible and expensive. Until recently, this has largely been true ... . Although the market has evolved and new products offer more flexibility, many consumers still are not responding." Annuities are also viewed as complex financial products, which makes them less appealing, the report said.

"The products will not be as good a value for the average consumer until the pool of lifetime income buyers increases. Unless value improves, however, the average consumer will tend to be reluctant to purchase the products. Disentangling this gridlock may take a while under a market-only approach," the report said.

Another complaint is that existing Labor Department regulations make it difficult for defined contribution plan sponsors to choose an annuity provider for those plan participants wishing to annuitize part of their savings. In 1995, the Labor Department issued Bulletin 95-1, which in part said plan sponsors not only were subject to fiduciary responsibility rules when selecting an annuity provider but must take steps calculated to obtain the "safest available annuity" unless it would be in the interests of participants and beneficiaries to do otherwise. A 2002 Labor Department advisory essentially affirmed that ruling.

But in the Pension Protection Act of 2006 (Pub. L. No. 109-280), Congress directed the Labor Department to clarify in a ruling that the "safest available annuity" provision does not apply to defined contribution plans. In September 2007 the Labor Department issued a proposed rule that in part would create a safe harbor to make it easier for plan sponsors to elect to offer plan participants an annuity option. The comment period on the proposal is closed, and a Labor Department spokeswoman told BNA her agency is working toward making the proposal final.

### **Long Fuse on Legislation**

Pension specialists on and off Capitol Hill contacted for this report said they do not expect legislation that encourages lifelong income streams for defined contribution plans to be approved by the 110th Congress.

"There's a certain level of pension fatigue" in Congress due to the intensity of discussions surrounding the Pension Protection Act, American Council of Life Insurers Vice President (tax and retirement security) Alane Dent told BNA June 10.

Despite that sentiment, Rep. Earl Pomeroy (D-N.D.), a leading congressional proponent of providing annuities for American retirees, introduced Nov. 9, 2007, the Lifetime Pension Annuity for You Act (H.R. 4150), which would exclude from taxation lifetime annuity payments of up to \$5,000 per year. The bill, referred to the House Ways and Means Committee, would also exclude from tax money used to buy longevity insurance, a lifetime annuity that enters into force if a retiree reaches a specific, advanced age.

Annuities provide security to retirees and should be encouraged, Pomeroy told BNA June 10. He said, generally, defined benefit plans provide greater retirement security to workers than defined contribution plans such as 401(k) plans, and added that a "core objective" for Congress regarding worker retirement benefits should be to ensure retirees possess lifelong income.

Another bill, the Women's Retirement Security Act of 2008 (H.R. 5543) would create for qualified retirees favored tax treatment for purchasing longevity insurance. The bill, introduced March 6, was sponsored by Rep. Thomas Allen (D-Maine), and was referred to the House Ways and Means Committee. A Senate companion bill (S. 1288) was introduced May 3 by Sen. Gordon Smith (R-Ore.).

The Senate passed a technical corrections bill to the PPA (S. 1974) by unanimous consent Dec. 19, 2007; the House approved its version (H.R. 3361) March 12. Pomeroy told BNA he anticipated a PPA technical corrections bill to be enacted before the 110th Congress adjourns in the autumn. But he said the bills as now written are flawed in part because they make funding defined benefit plans unpredictable and expensive.

### **Pomeroy Sees 'Bipartisan Confusion.'**

Pomeroy said Congress should focus on several areas concerning retirement when considering any new legislation in addition to finding ways to encourage retirees to annuitize at least a portion of defined contribution plans. For example, it should ensure Social Security remains a defined benefit plan and is in no way privatized, and also work to

make certain public pension plans are well funded and provide retirees with promised benefits

But Pomeroy, a former North Dakota insurance commissioner, said his work to bring these issues to congressional attention has been lonely, adding that Congress is "confused on a bipartisan basis" about the need to provide a greater degree of retirement security to working Americans. "I think that pension issues have not been well understood on the Hill," he said.

The congressman said that Congress will have to pay more attention to retirement issues as the U.S. population ages; one impetus may be exerted by baby boomers, who are now beginning to retire, he said.

PwC's Waidmann said providing retirees with a semblance of income security for life is an attractive legislative initiative for members of Congress to endorse, adding it could be slipped into a larger appropriations or tax bill.

Pomeroy said his bill providing tax benefits to individuals electing to annuitize part of their lump sum payments was affordable; Waidmann said the cost "probably would not be enormous."

But others, such as Sweetnam disagreed about the proposal's expense, saying that the cost could be perhaps unexpectedly high if a large number of taxpayers elected to receive the tax break. "These are expensive propositions for budget purposes. I'm not sure if I see any sort of legislative vehicle right now that would include this sort of thing," he said.

Salisbury said individuals' behavior may not change even if favored tax treatment were enacted. If a tax incentive excluded from tax \$1,000 or even \$3,000 in annuitized income per year, those amounts might not be enough to persuade higher income earners to buy an annuity who would not otherwise be inclined to do so, Salisbury said. And lower income retirees already are in a lower income bracket and thus would not enjoy an appreciable tax benefit, he said.

### **Insurance Industry Push**

The insurance industry, which offers annuities to retirees, is strongly pushing for congressional action that would encourage retirees to annuitize at least part of their defined contribution plan payments, lawyers and pension specialists said.

ACLI's Dent, a registered lobbyist, said her organization favors legislation that would increase the number of workers that annuitize part of their retirement savings, and has logged considerable time on Capitol Hill in an attempt to raise awareness of the issue, she said.

Premiums from annuities and similar products are currently responsible for about half of life insurance company premium income, ACLI spokesman Jack Dolan told BNA. The data reflect a well established industry trend toward retirement security products, Dolan added.

The Investment Company Institute's Reid said the insurance industry will not necessarily be the beneficiary of an increasing interest in annuitization because the financial services sector generally is moving quickly to improve their products and offer both workers and retirees retirement vehicles that allay concerns associated with outliving retirement assets.

And Mass Mutual's Dickey said to label companies selling mutual funds as the trend's financial losers and the insurance industry as the winner is "way too much of a simplification." Mutual fund companies, for instance, are looking at developing new products that would include a partnership agreement with insurance companies that would provide income guarantees attached to the mutual funds, Dickey said.

Dent also said insurance companies are now offering an array of annuity products that include death benefits and other innovations that may make the products more attractive to consumers. Besides Pomeroy, Dent said House members supporting the concept of encouraging annuities include Rep. Stephanie Tubbs Jones (D-Ohio), while Senate supporters of the idea include Sen. Kent Conrad (D-N.D.).

Dent, echoing comments made by Pomeroy, said her organization tends not to support the idea of mandating workers to annuitize at least part of their lump sum retirement accounts, particularly since the plans are voluntary in the first place. ASPPA's Miller said her organization is working on a proposal that will address retiree longevity issues which is expected to be completed by the end of 2008.

Asked when Congress may earnestly take up the issue of the annuitization of retirement savings accounts, Dent predicted the 111th Congress would at least initially be more focused on economic stabilization and health care reform. Once those issues are dealt with in some fashion, she said, Congress may be ready to turn its attention to the issue of retirement security, including perhaps the reform of the Social Security system.

*The Retirement Security Project report is at*

[http://www.retirementsecurityproject.org/pubs/File/RSP\\_TrialIncomev4](http://www.retirementsecurityproject.org/pubs/File/RSP_TrialIncomev4)

*By Stephen Joyce*