PENSION RIGHTS
CENTER

PROTECTING AND PROMOTING RETIREMENT SECURITY
1350 Connecticut Ave., NW, Suite 206 I Washington, DC 20036-1739
P: 202-296-3776 I F: 202-833-2472 I www.pensionrights.org

Statement of Norman Stein

On Behalf of the Pension Rights Center

Before the ERISA Advisory Council

On the Subject of

QDIA and Lifetime Income

Submitted on October 6, 2024

This statement is submitted on behalf of the Pension Rights Center (PRC). Founded in 1976, only two years after ERISA's enactment, the Pension Rights Center is a national nonprofit, nonpartisan consumer organization committed to protecting and promoting the retirement income security of workers, retirees, and their families. For the past 48 years, the Center has helped individuals receive and retain the retirement benefits they have earned, educated them about their rights, and worked to improve the nation's retirement income programs. In addition, with support from the Administration for Community Living, PRC provides direct services to more than 2,000 individuals annually, as well as serving as the technical advisor for five regional pension counseling and information projects covering 31 states, which provide hands-on help to individuals with retirement income problems. PRC’s on-the-ground experience helping individuals informs our policy work and helps us to identify systemic problems in the private pension system, including issues that affect workers and their families negotiating the challenges of 401(k) plan stewardship.

401(k) plans, and especially self-directed 401(k) plans, might be called accidental retirement savings plan, since no one in 1978, when section 401(k) was added to the Internal Revenue Code, anticipated that they would displace the defined benefit plan as the primary employer-sponsored retirement savings vehicle for American workers. The increased use of 401(k) plans has posed significant challenges for the American retirement system. Karen Ferguson, the founder of the Pension Rights Center, called them “do-it-yourself” retirement plans, since unlike traditional defined benefit plans, every individual employee must decide (1) whether to contribute to the plan and if so, how much; (2) how to invest their plan savings; (3) whether to withdraw money from a plan before retirement and what to do with it if they do; and (4) once retired, how to manage and draw down their accounts to ensure that they do not exhaust their assets before they die.

We have made significant, but not sufficient, advances in the first two challenges through the employment of automatic enrollment to get covered employees to participate in their plan, and target date funds and QDIAs to improve the efficiency of participant's investment allocations.

An important if not the primary focus of your working group is on the last of these important challenges, creating lifetime income for participants in defined contribution plans through the incorporation of lifetime income features in a plan's QDIA. As we will explain, we think it is premature to endorse such a strategy because of the many critical issues and unanswered questions concerning the efficacy of defaulting participants into a lifetime income strategy through the various proposed mechanisms. Indeed, challenges remain even for plans that wish to offer participants elective insured or partially insured lifetime income options at the end of a participant's career.

Before further exploring the lifetime income conundrum as to defined contribution plans, we do want to note that the creative steps already taken to improve the performance of 401(k) plans—automatic enrollment, automatic escalation, qualified default investment arrangements, low-cost target date fund offerings—do not fully address the problems of our retirement income system. In any given year, despite these improvements, millions of American workers do not participate in an employer-sponsored retirement savings or defined benefit plan. In 2022, approximately a third of the population in the private sector lacked access to an employer-sponsored plan and only about 75% of those eligible participated, for an effective coverage rate of a little more than 50%. And the median account balance of those who actually do participate in such plans is only $35,286.[1]

And automating 401(k) plans is itself an imperfect remedy to the retirement problems to our nation's retirement income deficit. Not only will many workers opt out of plan participation or withdraw money

[1] The figure is based on a 2024 study of Vanguard's approximately five million account balances. See Vanguard, "How American Saves 2024, https://corporate.vanguard.com/content/dam/corp/research/pdf/how_america_saves_report_2024.pdf.

before retirement, but some will opt out of the QDIA rules or ultimately take money from the plan and roll it into an IRA, where investment advice to unsophisticated investors is too often too lightly regulated and QDIAs do not exist.[2] And even in a world with a perfectly designed 401(k) plan, too many risks will continue to be borne by participants.

In short, we need policy solutions that expand not only the participation rate of those covered by workplace retirement plans but also push the total participation rate as close to 100% as we can muster. We also need to continue to look for new methods of providing retirement income beyond Social Security for those who are not covered by workplace plans. In particular, we need to encourage the further development of hybrid plan structures that include features that result in secure and adequate benefits throughout retirement and do not place all investment risk on the individual participant.

[2] A recent paper, albeit based on a small sample, concluded that automatic enrollment and escalation has a less profound effect on long-term savings behavior than originally thought. See James I. Choi, *et al, Smaller than we Thought? The Effect of Automatic Savings Policies*, available at https://spinup-000d1a-wp-offload-media.s3.amazonaws.com/faculty/wp-content/uploads/sites/27/2024/07/Automatic-policies-2024.07.21.pdf ("if policymakers wish to effect larger changes in savings rates, reducing the liquidity of retirement savings before retirement and increasing compulsory savings may be more effective.")

But now let’s return to the 401(k) plan and lifetime income options and consider the following four issues: first, should defined contribution plans include a default annuity as part of the QDIA; second, should plans offer full or partial annuity options as an elective choice at retirement or as part of asset accumulation; third, what are the types of managed, non-insured payouts that plans might offer to participants; and fourth, what measures might Congress adopt to encourage lifetime income, particularly among low and moderate-income workers?

A preliminary point: There is sometimes a sense that adding annuitization options to defined contribution plans will make such plans the equivalent of the historic defined benefit plans. This is not, however, the case. Such plans, which prior to ERISA seldom offered elective lump sums, were designed as income-replacement plans for retirees as groups. The underlying premise was not wealth creation but assuring income for life in retirement. The plans pooled most mortality risk without significant moral hazard; those with short life expectancies and those with longer life expectancies were in the same pool and participants generally did not have the option to opt out of lifetime income if they knew, for example, that they had a shorter-than-average life expectancy. These were true retirement income plans for a covered work force.

In contrast, in 401(k) plans (and most contemporary defined benefit plans, which offer lump sum options and often other annuity choices that include substantial non-spousal death benefits), annuitization is an elective tool for each individual participant to design a personalized strategy for managing their plan retirement savings after they stop working. It is not designed to maximize post-retirement lifetime income for a pool of all covered participants.

Now to the four questions we posed:

1. Should plans include a default annuity in defined contribution plans at retirement age or actual retirement? Behavioral economic principles have worked reasonably well at increasing plan participation rates and QDIAs have almost certainly resulted in better average investment outcomes for many participants. But unlike defaulting employees into plan participation or into QDIAs, which generally benefit almost all defaulted employees, defaulting plan participants into

annuities at retirement will have varying impacts—costs and benefits—depending on a participant’s individual circumstances. One powerful example: lower and moderate-income workers, for whom Social Security has a high lifetime income replacement rate. They may derive more benefit through access to liquid assets than annuitization of scarce assets beyond what Social Security already provides. Thus, a default option that annuitized all or most of their assets may not be in their best interests. Similarly, some individuals may benefit from using their 401(k) assets as a bridge to delaying the commencement of Social Security benefits until full normal retirement age or maximum retirement age (70), which will meaningfully increase their Social Security annuity benefit, which is indexed to future increases in the cost-of-living. And as a general matter, different individuals will have different needs in terms of how much, if any, of their 401(k) assets should be annuitized. There is simply too much variation in individual needs to default participants into a single standardized annuity.

An additional problem with a default into annuities is that life expectancies vary among groups, with lower and moderate-income individuals generally having shorter life expectancies than the average. Similarly, certain racial and ethnic groups have shorter life expectancies than other groups. Defaulting participants into annuities will likely result in some subsidization of longer-lived groups by shorter-lived groups.

Moreover, participants would have to evaluate the annuity unless plans were limited in the type of annuities that could be offered. Some annuity products, such as fixed-indexed annuities and certain variable annuities, contain complex, often expensive and, for many people, irrelevant features, that few consumers have the experience and background to evaluate. The decision as to the type of annuity, as well as the safety of the annuity, is a fiduciary decision and safe harbors, if ever appropriate in this area, should be limited to simple, straightforward annuity contracts whose periodic payments are not tied to market investment returns, either through actual investment performance of an underlying fund or through reference to market indexes. In short, because of the difficulty participants have in evaluating an annuity, it is imperative that the plan fiduciary examine the safety and nature of any annuity arrangement with the care and prudence generally prescribed by ERISA’s standards.

For all of the above reasons, we believe plans should refrain from, or least be exceedingly cautious about, providing an annuitization-at-retirement default as part of a QDIA. As with shoes and prescription eyeglasses, one size certainly does not fit all.

A second approach to default annuitization in a QDIA is for a QDIA to allocate a portion of every salary deferral and/or employer contribution to the purchase of a deferred retirement annuity. As part of a QDIA (or even as a stand-alone investment option), such an approach might mute somewhat the common behavioral reservations about choosing an annuity at retirement itself, when the choice is a large sum of money, whose value seems apparent, or a promise to pay a monthly amount, whose value is more difficult for many people to assess. In effect, purchasing a relatively modest deferred annuity annually might be more attractive than a one-time election at retirement. And a plan that takes such an approach would effectively convert a portion of a defined contribution plan into something very much like an old-fashioned defined benefit plan.

But the same concerns we raised earlier are present in this approach, as well—different participants will have different preferences and needs, and the participants will often be dependent on the fiduciary's best judgment in selecting the appropriate annuity contract and the percentage of annual contributions that would be used to purchase an annuity. In addition, there is the further concern of portability. An individual with ordinary job mobility might have to maintain an inventory of a number of deferred annuity contracts issued by different insurers, which could lead to lost benefits. While this problem could be remedied if there were a central clearinghouse to hold and consolidate annuity contracts or if the deferred annuity contract had a cash conversion feature, but a cash conversion feature would increase premiums and also largely defeat the purpose of including deferred annuity contracts as part of a QDIA.

Finally, it is critically important that if a plan offers an annuity as part of a QDIA, that participants receive, in both paper and electronic form, a clear and accurate description of any annuity that is part of the QDIA, noting both the benefits and drawbacks of converting an account into an annuity.[3]

2. Should plans offer full or partial annuity options as an elective choice at retirement or as part of asset accumulation? A plan offering an annuity option at retirement, or a deferred annuity benefit as an investment option during a participant's accumulation period, is generally desirable, since a guaranteed lifetime income stream can be a valuable financial asset for many participants. But it is important to ensure that individuals have the information and tools to determine whether to annuitize all or a portion of their account and that appropriate consumer protections—the fiduciary curatorial function in selecting appropriate annuity choices foremost among them—be in place. Standards should be developed that reflect the following principles and to the extent these principles are inconsistent with either the ERISA § 404(e) safe harbor or the settlor/fiduciary distinction, the Advisory

[3] See Section 2.B. below.

Council should consider recommending that Congress look at revising those rules to better protect participants, since complex annuity products, which are costlier than unadorned annuity contracts, are not appropriate for most individuals.

A. The responsible plan fiduciary should select annuity payment options only after determining that a particular option is in the best interests of participants and beneficiaries. The fiduciary process should include determining whether the features of the annuity are appropriate for the general plan population, and an evaluation of the claims-paying ability of the insurer and other considerations embodied in ERISA sections 404(e). The plan fiduciary should not select an annuity product without advice from an expert who agrees to fiduciary status under ERISA.

B. The plan should provide pre-enrollment materials to participants in both paper and electronic form, with no default into electronic communication. The Department of Labor should prepare a model statement that explains the benefits and drawbacks of full and partial annuitization. A plan might provide further, individualized counseling for participants.

C. A participant should be given at least a two-year "trial" period for an annuity selection.[4] During the trial period, payments should be made from a participant's account rather than through the purchase of the annuity, shifting to the annuity purchase at the end of the two-year period. The plan should notify the participant and the participant's spouse between 60 and 90 days before the expiration of the trial period to remind them of the election to opt out of the annuity and how to make it.

D. A plan offering an annuity should be required to offer a model annuity that is either a fixed monthly payment (with the option of reduction in monthly payment in the case of the participant or participant's spouse's death), or a monthly payment that is indexed to cost-of-living, with limited death benefits options for non-

[4] J. Mark Iwry, former Deputy Assistant Secretary for Retirement and Health Policy at the Department of the Treasury suggested such a trial period to the Advisory Council in 2008, when one of its working group issues was the Spend Down of Defined Contribution Assets at Retirement.

spousal or non-dependent survivors. We think there is reason to consider prohibiting plans from offering such products as fixed indexed annuities, but in no event should a plan be permitted to offer complex annuity products without also offering a straightforward, fixed monthly or inflation-indexed monthly annuity product.

3. Some ideas for non-insured managed payout mechanisms. We attach to our comments a draft paper[5] that includes some reflections on non-insured managed payout mechanisms (see proposals 2 and 3). In addition, the paper's sixth proposal, which suggests a pooled fund (rather than individual accounts) with investment allocations varying with risk tolerances presumed to be associated with age, could also provide a model for in-plan annuitization of retirees without purchasing annuity contracts from insurers. The plan using such a pooled fund could also provide lifetime income based on a designated rate of return and life expectancy tables similar to those used by commercial insurance

[5] John A. Turner and Norman P. Stein, Retirement Savings Plan Innovations in Participant Risk-Bearing (May 2024). The authors welcome comments on the paper.

companies, with actuarial shortfalls and gains reducing or increasing investment returns for non-retired participants, thus involving some intergenerational risk-sharing. Such a plan could also be structured as an adjustable annuity for retirees, with actuarial gain and loss allocated to the pool of retired participants in the form of a varying annuity amount.[6] These models may have the most potential in large plans, particularly firms in which participants will have long job tenures. The model would require considerable study to determine whether it is a viable approach to providing lifetime income.

4. Some ideas for government incentives for lifetime income. The Federal government might consider providing incentives for participants selecting an annuity at retirement age. There are several ways in which such incentives might be crafted. One approach would be to provide that if the participant elects to use all or part of an account balance to take an annuity, the government will provide a tax credit to be used to pay a percentage of the annuity premium.

[6] This arrangement has characteristics of a tontine. See Jonathan Barry Foreman and M.J. Sabin *Tontine Pensions,* UNIVERSITY OF PENNSYLVANIA LAW REVIEW 755 (2015).

A second approach would provide annuity distributions with favorable tax treatment, perhaps subject to capital gains rates or by exempting from income annuity payments to low- and moderate-income taxpayers. In the Netherlands, for example, pension benefits taken as an annuity are taxed more favorably than benefits taken as a lump sum.[7]

A third approach would be to provide tax incentives to the plan sponsor to create an employer-funded sidecar account, which would provide a plan match for the portion of the participant's account used to purchase an annuity. If the participant did not use the match, the sidecar account would be forfeited. With each of these proposals, a participant would be essentially leaving money on the table if they did not use at least a portion of their account to purchase an annuity. There are no doubt other ways in which the subsidy might be shaped and as we will discuss below, there would be reason to limit such subsidies to lower and moderate-income individuals.

[7] Organization for Economic Cooperation and Development (OECD). 2008. *Pension Country Profile,* available at https://www.oecd.org/finance/private-pensions/42574973.pdf.

No matter the approach and form of the tax subsidy—and whether it formally accrues to a participant or to the plan sponsor—these proposals would have revenue cost, and presumably, a more expensive subsidy, properly shaped, will have more effect. The revenue cost could be offset by reducing part of the basic tax subsidy, perhaps by reducing maximum contribution and benefit limits under Section 415 of the Internal Revenue Code. The revenue loss for the subsidy could also be reduced by limiting its availability so that it would only be available to low- and moderate-income individuals. This might also indirectly reduce the cost of the annuity by encouraging moderate- and low-income employees but not higher-paid employees into the annuity pool since the former have shorter life expectancies, which might be reflected in the premium levels charged by insurance companies.

A further option for obtaining an annuitized benefit would be to allow retirement savings plans to transfer all or part of their account to the Social Security Administration in exchange for an increase in their Social Security benefits. Social Security benefits are price indexed, which is generally not a feature of annuities that are purchased from life insurance companies. The PBGC might be another government agency that could offer a modestly priced annuity to participants in defined contribution plans.

Conclusion

Traditional defined benefit plans had as their purpose providing a lifetime stream of income in retirement. The structure of defined contribution plans does not as easily accommodate lifetime income, but as the Advisory Council's hearings demonstrate, there are strategies that can offer participants guaranteed or variable lifetime income options, but each approach involves tradeoffs. Including account annuitization as a plan default option appears to us to have significant shortcomings if we regard annuitization as an elective tool, which individuals can use when and to the extent it advances the individual's account spenddown needs and goals. We thus do not think it is the time to encourage use of a default annuity option in a QDIA, through safe harbors or otherwise. Moreover, it is important that participants are provided with appropriate consumer protections so that they can make knowing and informed choices about the value of full or partial annuitization of their account balances. And we encourage the Council to consider the efficacy of other approaches to making lifetime income options available to participants and their beneficiaries.