REMARKS AS PREPARED FOR DELIVERY
EMBARGOED UNTIL DELIVERY

Testimony of
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on Lifetime Income Options for Retirement

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Chairman Kohl, Ranking Member Corker, and Members of the Committee, I appreciate the opportunity to appear before you today to discuss policies to help seniors manage their assets in retirement so as to avoid outliving their savings.

As you know, on February 2, 2010, the Department of the Treasury and the Department of Labor jointly solicited responses to a variety of questions relating to the desirability and availability of lifetime income alternatives in retirement plans. Our Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans (the RFI) was prompted in part by the increased prevalence and use of 401(k) and other account balance plans, individual retirement accounts and annuities (IRAs), and other plans that tend to define benefits as an account balance and pay benefits as a lump sum, as distinguished from traditional defined benefit pension plans that traditionally have provided lifetime income. Guaranteed lifetime income alternatives are designed to convert savings into guaranteed future income, thus reducing the risk that a retiree's savings will be exhausted during retirement or eroded by investment losses.

The joint RFI has elicited nearly 800 written comments, evidencing careful thought and considerable effort on the part of many organizations and individuals – including labor unions, consumer groups, representatives of the financial services industry, employers, plan sponsors, plan administrators, academics, government officials and committees, and plan service providers, including third-party administrators, actuaries, consultants, and legal counsel. We at Treasury, together with our colleagues at the Department of Labor, are in the process of reviewing and evaluating each of these comments, and will continue working closely together as we consider potential next steps.

Background of the Lifetime Income Issue

It is well known that workers contemplating retirement face significant financial risks. Inflation, an uncertain rate of return on investments, and the insolvency of a former employer or financial provider are external factors that can deplete retirees' assets and income. Personal risks such as unemployment, illness, disability, and even life span can lower earning capacity or raise financial need.

Fortunately, life expectancy in our country has been increasing; but a long life can be hard to manage financially. Some underestimate how long they will live, focus on average life expectancy without sufficiently taking into account the 50-percent chance of outliving it, or otherwise neglect to plan for the possibility of many years in retirement. Many find it difficult to devise and adhere to a methodical plan for managing retirement assets over an uncertain, and potentially long, time horizon. Others, fearful of exhausting their savings, may unnecessarily restrict their spending in retirement. The problem of managing longevity risk is particularly salient for women, who generally have longer life expectancies than men.

Most working Americans enjoy a fundamental level of protection against longevity risk (as well as inflation and other financial risks) through Social Security, which provides retirees a basic foundation of guaranteed, predictable lifetime income. In addition, the private pension system plays a critical role in enhancing retirement security. Defined benefit pensions traditionally have played a central part in supplementing Social Security by paying predictable lifetime income to millions of working families. However, with the continuing shift from pensions -- classically, employer-funded programs such as defined benefit plans that generally provide predictable lifetime income at retirement -- to account-based retirement savings arrangements that depend mostly on employees' salary-reduction decisions and typically make single-sum cash payments at each change in employment, Americans' financial prospects for retirement increasingly turn on how much they save and how they manage their savings.

Congress, the Executive Branch, and many in the private sector have repeatedly expressed concern that Americans do not save enough and have emphasized the importance of long-term saving both for personal financial security and in the interest of expanding investment capital, promoting productivity, and continuing to raise our standard of living. To that end, the President has proposed, and the Administration is strongly committed to pursuing enactment of legislation to achieve a major breakthrough in retirement savings coverage and encourage Americans to become a nation of savers. Building on the success of automatic enrollment in workplace payroll-based savings vehicles such as 401(k) plans, the President's FY2011 Budget would provide for automatic IRAs for those not covered by employer-sponsored retirement plans. It would also expand the Saver's Credit to encourage savings by low- and moderate-income workers in employer plans and IRAs by increasing the financial incentive to save for the tens of millions of workers who are not in the higher tax brackets, i.e., the majority of working American families. See General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals, Department of the Treasury, February 2010, pp. 16-20.

Equally important is how individuals use the savings they have built up during the accumulation phase of their lifetimes. Particularly as the baby boomer generation reaches retirement age, we need to focus on how individuals manage their savings in retirement. In addition, the need for stable and assured income has increased because of longer life expectancies and retirement periods.

Traditionally, the most complete solution to this problem of managing savings to ensure a lifetime stream of income has been to protect retirees from outliving their assets through the use of guaranteed lifetime income, such as a defined benefit pension. Another option has been an annuity provided through a defined contribution plan, an IRA, or otherwise. Annuities and other lifetime income arrangements are designed to make predictable payments for as long as annuitants are alive.

Yet in recent years the use of annuities and other lifetime income streams in retirement plans has declined. Unfortunately, defined benefit pension plans, a traditional source of low-cost lifetime income, have declined; and defined benefit plans increasingly offer and make lump-sum (single cash) payments, either by adding a lump-sum option to the plan's payout choices or by converting the plan to a different, lump-sum-oriented format.

Cash balance plans are the most common example of this kind of hybrid design, in which a participant's benefit is primarily communicated as a lump sum. In addition, many employers have adopted 401(k) plans, where a worker's accumulated savings are typically paid upon retirement as a lump sum rather than as monthly payments for life. Moreover, workers who take lump sum distributions from employer-sponsored plans often roll over these distributions to IRAs which can, but typically do not, provide guaranteed lifetime income. To put this into perspective, out of total private pension assets of about $9.7 trillion at the end of 2009, only 22% were maintained in defined benefit plans, with the remaining 78% held in defined contribution plans (34%) and IRAs (44%).[1]

Objectives of the RFI

The RFI reflects the Departments' belief that, as the older segment of the population has grown, people are seeking more advice and assistance with the challenge of how to manage and draw down their retirement benefits and savings. Plan participants very commonly take their accumulated retirement savings as a lump sum payment, which requires them to manage that sum to last the remainder of their lives (or their and their spouses' lives). However, it is difficult or impossible for an individual to predict the length of his or her lifetime. Even those familiar with actuarial life expectancies have, by definition, a 50% chance of living longer than the average. Many people with retirement savings might be expected to hedge the risk of living longer than expected by taking at least some of their retirement plan or IRA distributions in a form that pools longevity risk with others and assures a continued stream of income no matter how long they may live. By and large, however, they do not, despite economists' suggestions that many more people would be better off – would maximize their utility – by choosing to take at least a portion of their benefits as a guaranteed lifetime income stream. (The economic literature sometimes refers to this phenomenon as the "annuity puzzle".)

The RFI was not premised on any preconceived conclusions as to why more plan participants and IRA owners are not choosing payment forms that guarantee lifetime income streams, what (if anything) to do about this, or whether additional lifetime income is necessarily the best choice for everyone. An individual whose retirement savings are small, for example, may be well advised to keep those amounts liquid rather than locking them away in a form where they could

[1] Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, Statistical release Z.1 (June 10, 2010)

not be drawn upon for emergencies or other unanticipated events (and, in any event, annuitization would not cure the problem of inadequate savings). Conversely, providing for assured lifetime income may be unnecessary for those with so much wealth that they need not worry about outliving their resources. In addition, purchasing a lifetime income guarantee might not be desirable for someone who, because of serious illness, faces a very short life expectancy. Excluding these groups of people, however, still leaves many who might be expected to find assured lifetime income alternatives more attractive than is reflected in the actual utilization of lifetime income.

The RFI sought information intended to help determine whether Treasury, the Department of Labor, or other government agencies can take any constructive steps to ensure that retirement plan and IRA participants do not encounter unnecessary obstacles in choosing between regular income and other alternatives. We are interested in increasing the availability of lifetime income as an option and facilitating individuals' informed choice among options – without mandating any particular choice.

Moving Forward

The nearly 800 comments received in response to the RFI included many that were very detailed, and included many useful insights. We are carefully reviewing them and analyzing the issues they raise. Discussing specific administrative guidance or possible legislative proposals at this point would be premature, but a number of recurring themes are worth noting:

- There are any number of reasons why individuals may be reluctant to opt for a lifetime income alternative. Among those mentioned in comments are

    - Concern about giving up control over investments (something participant-directed 401(k) plans have conditioned participants to expect).
    - A desire to maintain asset liquidity and flexibility in order to meet unexpected financial needs.
    - A general reluctance to take all or most retirement savings in a form that may disappear after an annuitant dies.
    - A desire to leave a bequest.
    - A concern that, if a lifetime income stream does not adjust for inflation, its value could erode over time.

- The questions raised in the RFI encompass not only employer-sponsored retirement plans but IRAs as well. However, employer plans may be a particularly appropriate venue in which to present lifetime income options. Plan fiduciaries may be able to gather the information and acquire the expertise to help select or design lifetime income arrangements or products that are suitable for and appropriately protective of individuals and that are cost-effective. They may be in a better position to select providers and may be able to exercise more bargaining power in the market than individual plan participants, obtaining institutional rather than retail prices. Plan sponsors also can be a valuable source of information and education for plan participants. In addition, the prospect that numerous plan participants may opt for more lifetime income could reduce adverse selection and thereby reduce costs.

- There is a recognition that deeply deferred annuities that might begin as late as the individual's life expectancy – sometimes called longevity insurance – could play an important role in providing lifetime income, especially by offering individuals a different type of tradeoff between retention of flexible assets and provision of future guaranteed income. Providing protection against the "tail risk" of running out of assets after age 85, for example, generally would entail less reduction in an individual's current account balance than purchase of an immediate annuity and might therefore present itself as a more attractive choice for some individuals. However, concerns have been expressed that the required minimum distribution rules under Internal Revenue Code section 401(a)(9) may impede the use of this alternative.

- Often the choice of lifetime income is presented or perceived as an all-or-nothing choice, which may have the effect of discouraging people from selecting any lifetime income. In fact, however, many individuals might best achieve their personal objectives by applying only a portion of their retirement savings to a lifetime income option, while continuing to invest the remainder and draw it down as needed.

    - We are considering whether regulations or other guidance present any unnecessary impediments to choosing partial guaranteed lifetime income.

- This all-or-nothing framing of the lump-sum versus income choice can arise in defined benefit as well as 401(k) and other plans. In fact, it may be particularly important to consider this issue in the defined benefit context, because those plans, in contrast to a majority of 401(k) plans, already offer lifetime income options (and indeed are required to make them the default option).

- Financial education is a critical part of the sustained effort likely to be needed to ensure that choices relating to lifetime income are informed choices. The choice between an income stream and a lump-sum distribution may be among the most important financial decisions a person ever makes. Because defined contribution plans (and cash balance plans) express benefits as a single sum account balance, participants may experience what some call "wealth illusion," making them feel “cash rich” even though the lifetime income stream that can be provided by that single sum (particularly taking inflation into account) may be much smaller than they might expect. Education centered on, among other things, making the relationship between the account balance and the lifetime income stream transparent and more readily understood may improve planning and encourage more adequate saving.[2] (One aspect of the choice that may not be readily

[2] During the Clinton Administration, the Treasury Department was very active in financial literacy and education efforts. Those efforts were formalized in 2002, with the creation of the Office of Financial Education in the Treasury Department. That office promotes access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, home ownership, and retirement planning. It also coordinates the efforts of the Financial Literacy and Education

apparent to many individuals is the asymmetry between the risks presented by variable investment experience in the spend-down phase by contrast to the accumulation phase, specifically the risk that years of investment gain can do far less to help a portfolio recover from previous years of investment loss if the pattern of loss followed by gain occurs while a retiree is regularly withdrawing from the portfolio during spend-down rather than while an active worker is regularly adding to it during the accumulation phase.)

- Information and education as to the costs and benefits of available lifetime income alternatives is important. Plans and IRAs (and the annuities or other financial products associated with them) necessarily involve expenses for recordkeeping, administration, and insurance-related charges for lifetime income guarantees. It is critical, however, that fiduciaries and individual participants be able to understand and compare, with the aid of good disclosure and clear explanations, lifetime income products (including both their benefits and costs). Ensuring access to such information should help fiduciaries and individuals make more informed choices and empower them to evaluate whether a product offered in the marketplace is appropriate for their needs. Informed individual choices, in turn, should lead to increasingly cost-effective means of delivering lifetime income.

This is by no means an exhaustive list of the issues that need to be, and will be, considered. For example, Chairman Kohl submitted to the Departments an important comment on behalf of the Committee calling attention to a helpful Government Accountability Office (GAO) report, entitled "Retirement Income: Challenges for Ensuring Income through Retirement." The comment also discussed the "Lifetime Income Disclosure Act" (S. 2832), introduced by Senators Bingaman and Isakson, together with Chairman Kohl. This bill would, among other things, require 401(k) and other individual account plans to provide participants an annual statement with estimates of how much their accounts would buy in lifetime monthly payments starting at normal retirement age.

We believe that information of this type -- the potential income equivalent of an account balance -- could be valuable for workers facing critical decisions regarding how much to save and how to deploy their resources at and before retirement. As creative work in behavioral economics has illustrated, the way potential benefits are presented or "framed" can have a potentially consequential impact on the way people approach these important decisions. Accordingly, the RFI requested comments on the possibility of providing such information. The comments submitted on disclosures in benefit statements -- which is a topic within the Department of

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Commission, a group chaired by the Secretary of the Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States. Treasury's Office of Financial Education, the Department of Labor's Saving Matters Retirement Savings Education Campaign, and the extensive financial education and outreach efforts under way in the private and nonprofit sectors (including by plan sponsors) can help give individuals the information and understanding to make more informed choices relating to lifetime income and retirement and financial security more generally.

Labor's regulatory jurisdiction -- are helpful in addressing the advisability and feasibility of providing participants with this type of information and how best to structure any such disclosures. As some of the comments point out, relevant considerations include the need to balance the value of giving participants information on the income equivalent of their accounts with any administrative burdens and costs of providing the information and with the need to avoid information overload that could discourage people from considering the information in the first place.

The RFI responses suggest that lifetime income products are evolving in ways intended to address some of the concerns of plan participants and sponsors.[3] Death benefits, withdrawal options, participation in equity returns, and other features can encourage individuals to opt for income options but also can make it more difficult for consumers to understand the options and their costs and to compare products on an "apples to apples" basis that promotes effective price competition in the market. These developments and the continued evolution of cost-effective, transparent, and readily understandable designs should help plan sponsors offer participants a variety of improved options for obtaining lifetime income. As noted, defined benefit plans have traditionally provided such income. Taking into account the increasing role of 401(k) plans and IRAs, it is important to encourage the availability in the individual-account universe of payment options that were formerly more prevalent in defined benefit plans. Meeting that goal will not be easy, and will not occur overnight, but we believe it is a goal worth pursuing.

The RFI also does not address investment risk. We have seen how investment losses can hurt individuals in or near retirement, but this project is not focused directly on that problem (although guaranteed lifetime annuity products, such as a fixed annuity purchased before retirement, may help mitigate investment risk). This Committee has exercised leadership with respect to investment risk with its hearing on the effect of the economic downturn on retirement security, particularly for those on the brink of retirement, with a particular focus on 401(k) target date funds and on the wide variety of objectives, portfolio composition, and risks that exist within same-year target date funds.

Finally, we should keep in mind that the RFI and lifetime income discussions are relevant only to the roughly half of the workforce that has tax-favored retirement savings. We also need to address the problem of insufficient savings in the accumulation phase, for example through legislation on automatic IRAs and an enhanced Saver's Credit.

Conclusion

Mr. Chairman, Ranking Member Corker, and Members of the Committee, thank you for the opportunity to appear before you today. I will be happy to respond to any questions.

[3] Comments also note the availability of new non-annuity products and services that address a range of retirement income needs. For example, certain managed payout funds, meant to serve as combined investment and payment vehicles, are designed to provide predictable monthly payments over an extended term, although not guaranteed to continue for life.