TESTIMONY BEFORE THE ERISA ADVISORY COUNCIL WORKING GROUP ON RETIREMENT PLAN DISTRIBUTIONS AND OPTIONS

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The Profit Sharing/401k Council of America (PSCA) is a non-profit national association of employers who sponsor defined contribution retirement plans for their workers. For over fifty-five years, PSCA has identified and shared best practices with its members, represented their interests in Washington, and provided analysis and reportage on the latest regulatory changes. PSCA members range in size from very small independent businesses to firms with hundreds of thousands of employees. Our members believe that profit sharing, 401(k), and related savings and incentive programs strengthen the free-enterprise system, empower and motivate the workforce, improve domestic and international competitiveness, and provide a vital source of retirement income.

The Working Group seeks the answers to three questions.

1. Are retirement and distribution options being effectively communicated to retiring and withdrawing participants to facilitate individual management of their retirement plan asset?

Plan sponsors are aware that their employees need assistance with retirement-related financial decision-making and increasingly they are doing something about it. 55.3% of the respondents to PSCA's 47th Annual Survey of Profit Sharing and 401(k) Plans reported that in 2003 their companies provided special education programs to help their retiring employees determine how to manage their defined contribution plan accumulations. These programs are often extensive. Some companies provide employees and their spouses with pre-retirement counseling seminars. Many provide financial planners for one-on-one consultations. Others provide access to modeling programs and distribute extensive written material to their pre-retirees.

Financial services companies, broadly defined, and individual financial planners also recognize that retirees need help managing their money in retirement and are increasingly part of the solution. For example, financial services companies, in addition to providing access to a wide variety of investment services and solutions, have developed planning software to help retiring participants with their decision-making. The financial planning community is encouraging financial advisors to get special training in retirement planning and has developed special designations for those who do.

The growing employer commitment to successful defined contribution outcomes, combined with market forces, are moving to provide communications, education and advice solutions for retiring defined contribution plan participants.

2. Should life only, joint and survivor and period certain annuities be mandatory options offered in defined contribution qualified retirement plans in addition to existing options such as lump sum distributions and other forms of account balance liquidation?

The government should not impose additional requirements on defined contribution plan sponsors unless there are compelling reasons to do so. There are no such compelling reasons for the government to mandate that annuities, and especially specific annuity products, be offered as distribution options from a defined contribution plan. In fact, requiring that plan sponsors make specific annuity products available through their defined contribution plans may harm the defined contribution system and limit its benefit to retiring participants.

First, average wage workers already are provided with a substantial annuity when they retire. According to the 2005 Social Security Trustees Report, the average 65 year old retiring in 2005 will receive a Social Security benefit that replaces 43.2% of pre-retirement income. Those with average earnings at 45 percent of the national average will receive an annuity equal to 65% of their pre-retirement income. These annuity payments are subsequently adjusted for inflation. Married couples can each elect to receive their own benefit or 150 percent of the higher benefit. For the average wage earner with a spouse who does not work, social security will replace 64.8 percent of income. Social Security provides a 100 percent survivors benefit. In two-earner families, the surviving spouse can switch from their own benefit to the spousal benefit if it is higher. According to the 2004 Aon Consulting/Georgia State University Replacement Ratio Study, the income replacement ratio of a retiree with $40,000 in pre-retirement income is 80%. Social Security will provide over half.

Second, the evidence that those taking lump sum distributions from their retirement plan are not purchasing annuities is inconclusive. It is true that for the approximately 25% of defined contribution plans that offer annuities nearly all retirees take a lump sum/IRA rollover or leave their assets in the plan. However, some or all of an IRA balance may subsequently be used to purchase an annuity and retain the tax favored status of the distribution. When it makes sense to purchase an annuity, retirees may be doing so. For example, my father annuitized his tax deferred accumulations when he was 80. It would be interesting to know the percentage of IRA assets invested in annuities and when that annuitization occurred.

Third, there is no evidence that participants who choose not to purchase annuities through their plan when they retire are harming themselves. For example, for how many does it make sense to make the irrevocable decision to purchase an annuity at age 62 or age 65, especially when the annuity options available do not provide for inflation adjustment? Does it make sense to convert a lump sum to an annuity when the purchase rates are at historic lows? A December 2002 report by the TIAA-CREF Institute[1] provides some insight on participant's preferences for various distribution options at the time of retirement. Prior to 1989 an annuity product was the only distribution available under the plan. Non-annuity options were added in 1989, 1991, and 1996. By 2001, only forty-five percent of new retirees selected an annuity payout. These participants were furnished with illustrations of the income levels of various options at the time of retirement. According to the report, "The choices individuals are making therefore do appear to be made willingly and voluntarily, reflecting consideration of the available options."

Fourth, mandating that defined contribution plan sponsors offer specific annuity approaches would stifle innovation. Within the next six months an insurance company will market an annuity approach that permits the retiree to maintain their lump sum in an IRA but gradually annuitize some or all of their

[1] John Ameriks, , Recent Trends in the Selection of Retirement Income Streams Among TIAA-CREF Participants, Issue Number 74, TIAA-CREF Institute, December 2002

deferred accumulation considering the retiree's risk, investment and estate preferences. This product will have the following features:

- All options can be stopped, started and changed at any time
- Automated Required Minimum Distribution (RMD) Compliance
- Automated quarterly rebalancing
- COLA / Inflation Protection Option
- Dollar cost averaging annuity purchase
- Flexible Income Start Age
- Survivorship Benefit Option (50 – 100%) for spouse
- Legacy Benefit Option (25 – 100%) for heirs and beneficiaries
- Benefit Exchanges – Reduce Survivor or Legacy benefit in exchange for more income
- Liquidity Reserve Option (0 – 12 Months of Income) in a cash account

This approach will permit the retiree to move to a secured income based upon their risk tolerance, their chosen level of guaranteed income and their chosen period to fund an annuity. Every retiring employee's situation is unique. Retirement management decisions need to consider age, marital status and other family factors, health, wealth, potential inheritances and genetic dispositions. Government intervention will discourage the innovation needed to address our diverse retiree population.

Fifth, plan sponsors do not provide annuities as a plan option for good reason. Any defined contribution plan sponsor offering an annuity option must manage attendant administrative and compliance requirements. For example, a waiver of the QJSA annuity option can not be done electronically. The DOL should consider addressing this issue. Sponsors offering a plan annuity option assume fiduciary responsibly for selecting the annuity vendor. Sponsors know that where annuity options are offered they are not utilized. Also, their own employees have not asked for an annuity option. Finally, sponsors know that if a retiring or retired participant wants to annuitize some or all of their lump sum they can do so in an IRA. To keep the defined contribution system healthy and growing, especially among smaller employers, it is important to avoid plan regulation that imposes additional administrative responsibilities, compliance obligations and fiduciary liability, like those that would accompany the mandatory offer of an annuity.

In conclusion, in the decades ahead trillions of dollars from employer defined contribution plans, and the IRAs funded by employer defined contribution plan distributions, will be available to support the retirement of today's workers. As a result, service providers will compete, and should be forced to compete, aggressively with innovative services and products tailored to the individual needs of retirees if they want a role in managing these assets.

The government should not mandate that annuities, and especially specific annuity products, be offered as distribution options from defined contribution plans. Such a requirement would discourage plan formation and deny retirees the innovation in products and services that they will need to effectively, efficiently, and safely manage their retirement assets.

3. Should phased retirement be an option for plan participants? What are the tax, funding and ERISA issues of "phased retirement?" Do these issues raise impediments to plans design that can/cannot be overcome?

There are many benefits of phased retirement and employers should have the flexibility to design programs that permit it. Fortunately, defined contribution plan sponsors who wish to permit phased retirement can do so beginning with the year in which a participant is 59 ½, and many do. According to PSCA's 47th Annual Survey of Profit Sharing and 401(k) Plans, approximately 75% of employers permit their defined contribution plan participants who have attained the age of 59 ½ to withdraw assets from their defined contribution plan and continue working. Every plan about which I know permits participants to continue to accumulate assets in their accounts after the age of 65, even if they are part-time. In fact, one major retail employer has tens of thousands of employees over the age of 65 who participate in their defined contribution plan.

The Working Group also posed a number of potential questions for potential witnesses. I have answered a number of them below.

1. What are the plan distribution options available to defined contribution arrangements? 2. What are the most prevalent distribution options found in defined contribution plan design?

According to PSCA's 47th Annual Survey of Profit Sharing and 401(k) Plans, in 2003 99% of plans permitted lump sums distributions, 55.4 % permitted installment payments and 26.5% offered a plan provided annuity. All permit participants to rollover their balances into an IRA. Importantly, 72.2% of plans permitted participants to leave their balances in the plan after they retired. This was true at 86.6% of the companies with more than 5,000 plan participants.

3. How and when are the retirement/termination plan asset withdrawal options communicated to the participants?

The options themselves are communicated through the SPD, on the plan website and in information packets provided to potential retirees.

4. What financial advice is provided to retiring/withdrawing participants regarding effective use of their defined contribution plan asset?

55.3% provide additional information to help retirees make distribution related decisions. How this is done varies by company. I believe that the availability of planning advice is growing.

5. Why do you think a defined contribution plan sponsor might delete or avoid annuity distribution options?

See previous discussion.

6. What is the effectiveness in meeting retirement income needs to life expectancy from existing defined contribution distribution options?

Retirement income adequacy is a function of initial fund balance and appropriate asset management in retirement. It is difficult to determine on a generic basis because the range of individual need in retirement is so wide. Defined contribution plans can meet any accumulation target provided the time, amount saved and return are sufficient. For discussion purposes, the 2004 Aon Consulting/Georgia State University Replacement Ratio Study indicated a male participant with $40,000 in pre-retirement income needed a lump sum equal to 3.4 times final pay or $136,000 to purchase an annuity that, when added to their Social Security, would equal the 80% income replacement that they say is needed to replace net pre-retirement purchasing power. Female participants need a lump sum of 3.9 times final pay or $156,000.

7. Do retirement distribution options available from IRAs into which qualified plan distributions may be rolled over provide sufficient variety to effectively provide options beyond what might be available in a particular qualified defined contribution plan?

Every financial management option, except those where leverage might generate margin calls beyond the value of the account, are available within an IRAs.

8. Can individual commercial annuities be utilized to completely transfer longevity risk from the plan sponsor and plan participant?

Defined contribution plan sponsors have no longevity risk.

9. Do group annuities exist with group annuity pricing for the purpose of transferring longevity risk from plan sponsor and plan participant?

Annuities can be provided through a defined contribution plan with group pricing. However, plan-level group pricing is not always the best pricing. When I assisted retiring participants with an annuity purchase, we shopped the lump sum with several companies and always beat the group annuity price provided the plan.

10. Would annuities offered as an option through a qualified retirement plan require unisex pricing? Would COLAs be available on such annuities, not unlike COLA provisions in defined benefit plan income streams?

Unisex pricing is required for annuities from all qualified retirement plans. To my knowledge, no company provided defined benefit plan has COLA provisions.

11. What is the effectiveness in meeting retirement income needs to life expectancy from commercial annuities? Do immediate annuities have COLAs to hedge inflation risk?

A substantial amount is invested in commercial annuities each year. Inflation adjusted annuities are very rare. According to a recent Walls Street Journal article, Vanguard offers such a product in conjunction with AIG, but very few customers are willing to pay the 20 to 30 percent initial income payment reduction resulting from the inflation protection.

12. Are there benefits from an expense and investment perspective to having periodic distributions made from an account either in a defined contribution plan or in an IRA over a stated period (which could be defined as the life expectancy of the participant) without utilization of an annuity contract?

A financial planner should be asked to provide the worksheet they use to do the cost benefit analysis.

13-17. PSCA’s comments regarding phased retirement are summarized in the response above.