

# Memorandum

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[william.charyk@arentfox.com](mailto:william.charyk@arentfox.com)**Date:** June 30, 2015**To:** Mark Iwry**Cc:** Harlan Weller  
Bill Evan  
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Robert Melia**From:** William R. Charyk**Re:** Follow-up to IRIC Meeting with Treasury on May 1, 2015

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## Introduction

Preliminarily, please let me convey that the sincere thanks of all members of IRIC who were able to meet with you and your team on Friday, May 1, 2015. We much very appreciated the opportunity to express our views on certain topics and to discuss with you and your team some of the issues that Treasury is reviewing in connection with the general area of retirement income products.

The purpose of this Memorandum is to briefly summarize the three areas in which we respectfully requested consideration of the development of guidance. In addition the Memorandum will provide you with some additional information in areas identified in our dialogue. Finally, we have identified possible topics for further exploration which are related to other previously identified items.

As a general matter, IRIC is very interested in the issuance of guidance from Treasury that parallels the guidance provided in Notice 2014-66 and the QLAC guidance issued in July of 2014. IRIC believes that guidance from Treasury will eliminate an impediment to future product development and plan sponsor consideration of products that may exist as a result of some uncertainties in the areas. Such guidance should provide a catalyst to retirement income product development efforts and/or a catalyst to plan sponsor consideration and eventual product selection of retirement income products. We have seen some development efforts – especially in

the IRA space, as a result of recent guidance and we believe that clarifying guidance regarding GMWBs will foster careful review and ultimate adoption of retirement security investment vehicles.

## Summary of Three Areas with Respect to Which Additional Guidance was Requested

(1) Discrimination Issue – We noted that the typical GLWB offered as an investment option within a 401(k) Plan will, as a matter of product design, be available only to individuals who have attained a specified age, such as age 50. In some cases, neither the investment component nor the lifetime guaranty feature of the product will be available until an individual has attained a pre-specified age. In other cases, the product may be available as a general investment vehicle prior to any specified age but the element of guaranty is not triggered until a specified age is achieved. We would like to obtain some guidance that the age restriction associated with the project would not involve an element of discrimination that could otherwise adversely affect the tax qualified status on the underlying Section 401(k) Plan. It would appear that guidance in this area was extended in connection with the product discussed in Notice 2014-66

(2) RMD Issue – IRIC believes that providing GMWB relief that is similar to the relief provided to QLACs would simplify the administration of GMWB's and be a welcome consumer friendly approach to RMDs. Specifically, IRIC believes that guidance issued that would allow a plan participant to consider only the Market Value of the GMWB, based upon the actual asset base without regard to the actuarial present value of the Guaranty Components of the GMWB would bring consistence to recordkeeping systems and would convey RMDs to participants in a manner they can readily understand. QLACs have been provided with similar relief. If the QLAC meets certain requirements, then the value of the QLAC is excluded when calculating RMDs, and the payments from the QLAC (whenever they begin) are implicitly assumed to satisfy their RMD obligation. For GMWBs a simple yet elegant solution would be to disregard the marginal value of the future Guaranty under the GMWB above the market value for purposes of calculating the required minimum distribution. When and if the GMWB asset account is exhausted, the remaining payments the insurance company provides would be considered an irrevocable annuity at that time and these payments would also satisfy the RMD rules.

(3) Joint and Survivor Annuity Issue – As we discussed, providers in the area have adopted one of three positions with respect to the applicability of the spousal consent/joint and survivor annuity rules with respect to these products. The first position is that the product simply does not constitute an annuity and therefore the joint and survivor annuity rules do not apply at any time. The second position is that the product does not invoke the joint and survivor annuity rules unless and until the underlying asset base associated with the product has been exhausted and payments are being made pursuant to the guaranty feature of the product from the general assets

from the insurance company. The third position is that the joint and survivor annuity rules are invoked once the individual confirms the withdrawal base to be used to determine the amount of future guaranteed distributions and indeed commences receipt of periodic distributions from the plan. None of the product providers would take the position that the joint and survivor annuity rules apply prior to the date on which the product is utilized as a source of periodic distributions. In other words, a withdrawal from the product or a transfer of assets from the product to another investment vehicle available within the 401(k) plan prior to the commencement of a formal periodic withdrawal program would not trigger spousal consent.

IRIC is “neutral” with respect to which position should be asserted by the Internal Revenue Service. We do wish, however, that definitive guidance be issued so that all products can be offered in a uniform manner and potential consumer confusion can be avoided.

#### Proposed Definition of GMWB Product

As requested, we have attached in electronic form the generic definition of a GMWB which we presented at the meeting. Pursuant to your request, we have also reviewed the definition of the GLWB contract that was used in Notice 2014-66. We agree with the accuracy of the points made in your definition. However, your definition noted a distinction between a GMWB and a GLWB. The GMWB was originally established as a retail vehicle which provided for payments over specified time period, typically 14.2 years. The best of our knowledge, the GMWB is not offered within the context of 401(k) plans and therefore would not be a typical option for a Plan Sponsor to consider in reviewing alternatives to providing retirement income.

#### Comparison of GLWB Products

We have taken the liberty of attaching a copy of the current versions of the product description sheets made available by IRIC in respect of a variety of GLWB products. In addition we have attached the electronic copy of an analysis undertaken by Lincoln with respect to a range of current products.

#### Illustrative Communication Procedures with Respect to Withdrawals in Excess of Guaranteed Amounts to Promote Consumer Protections.

Treasury expressed interest in obtaining some additional information regarding the efforts which insurers and record keepers have made to help participants make wise withdrawal decisions regarding the guarantees that are part of a GMWB contract so they do not intentionally or inadvertently surrender the guaranty values inherent in the GMWB contracts. Before detailing some of these consumer protection steps, it should be noted that the industry should embrace any responsible set of consumer guidelines since the essence of a GMWB contract and the very

reason for their development was to protect consumers / participants from a variety of risks and damaging outcomes. These products protect consumers by inherently providing:

- Downside Market protection – GMWBs are really a different asset class. Participants are protected from volatile equity and bond markets and view this type of investment differently than conventional equity or bond investments in the application of their declared level of risk tolerance to investment selection.
- Better Asset Allocation. Appropriate asset allocation can be the single most important factor for a near retiree's security. The downside protection provided to participants enables participants to stay appropriately invested with some exposure to the equity market. Without this protection some retirees may choose to over-concentrate in the cash equivalent arena - causing them to miss out on market advances
- Timing Protection – Glidepath design in TDF – Some programs utilize GMWBs in connection with a “Glidepath” allocation strategy so a participant who does want to make periodic timing strategies as between investments can benefit from a graduated increase in his proportionate investment in GMWBs.

Behavioral Protections – GMWBs contain a series of implicit consumer protections that include and mitigate: cognitive risk, longevity risk, sequence of return risk, point in time interest rate risk, inflation risk (in part), Death Benefit, spousal protections (death or longevity). DC plans without GMWBs do not have these built-in consumer protections

Our DC industry is based on participant choice with appropriate education and disclosures. TGMWB – like contracts have been available in the retail space for 10+ years with very few consumer problems or complaints. GMWBs offered in the context ERISA DC Plans already have significantly more protections than those offered in the retail marketplace.

In addition to the above, the insurance industry and the record keeping industry have developed a number of safeguards to further protect participants. These include:

- Liable – but not loanable – Some members allow plans to enable the GMWB investment to be considered in the loanable amount – but do not allow the GMWB to be used to fund the loan thus preventing an excess withdrawal
- Last fund Debited – Rather than prohibiting a GMWB from serving as a funding source for a loan outright, a Plan may designate a fund withdrawal order where the GMWB is the last fund debited for loans and withdrawals. One provider has the following sentence in the loan policy statement that governs a plan's loan processes. It reads: “*If you have*

*the (GMWB product) investment option, the GMWB fund will be used last to fund any loan requests, or service charges associated with the loan”*

- Re-balance restrictions – Automatic fund rebalancing programs triggered by market value fluctuations could cause withdrawals from the GMWB funds if the GMWB fund enjoyed a disproportionate increase in its relative value within a participant’s portfolio. At least one provider has restricted participant’s ability to automatically rebalance their portfolio so that market fluctuations would not create an inadvertent withdrawal from a GMWB fund.
- Pop ups - Pop up messages can be applied to certain transaction done on the Web. Transfers, Loans, etc.
  - a) Below is the actual language that is used on a provider’s record keeping system when a participant attempts to rebalance or transfer their balance out of the guarantee: *“Warning prior to submitting exchange out of SRI: “Removing money from guaranteed income (GI) investment (Product Name). Removing money from guaranteed income (GI) investment (Product Name) may forfeit all or part of your guarantee. . . Please call 888 888 8888 to discuss this transaction”*
- Call center transactions - Certain transactions with some providers can only be executed by a call center (for example a participant that has Income base of \$100 k and Market value of \$70 k must talk to a phone rep before liquidating the Market Value and losing the associated guaranty).
- Portability is available by all providers to an IRA product. Also, at least four providers (perhaps more) have parallel IRAs that have either the same fees as the institutional version of the GMWB product or an IRA version that is less expensive than their retail version
- Abundance of education including in some cases one-on-one education is provided by all providers using enrollers or advisors so that participants are educated about their investment and guarantees
- It is not in the Insurers best interest to allow inadvertent (or intentional) mis-use of the products. The reputation risk would far exceed any benefit that an insurer could acquire from a surrender or inadvertent withdrawal. In addition, the insurer has much more at stake with the DC plan itself and would not jeopardize its DC relationship for any possible gain from an individual surrender

## Response to Forfeiture Concern Expressed by Harland Weller

We have given significant thought to the concerns expressed by Mr. Weller with respect to a situation where individual withdrawals more than the annual guaranteed amount from the product and therefore reduces or perhaps eliminates the withdrawal base upon which future guaranteed payments are determined. We have begun to develop some thoughts to offer for your consideration in this regard but realized that we may not have a full appreciation of the scope and measures of Mr. Weller's point of view. Accordingly, we would like to take the liberty of setting forth below a summary of what we understand to be the substance of Mr. Weller's concern. Certainly if we have omitted or misunderstood any element of the issue, we would appreciate clarification and correction so that we can properly address this concern in a constructive and hopefully useful manner. We understand that concern to involve the following points:

- (1) Payments from the Section 401(k) Plan must consist of payments attributable to a participant's account, adjusted to reflect the earnings experience of the account.
- (2) Accordingly, to the extent that payments are made pursuant to a guarantee under a GLWB after the underlying asset base associated with the product has been exhausted, such guaranteed payments must be in the nature of earnings in order to be a payment that can legitimately be made from a defined contribution plan.
- (3) To the extent that such payments are characterized as "earnings" they are part of the account and are subject to the vesting rules of IRC Section 411.
- (4) To the extent that an individual withdraws more than the guaranteed amount from the contract or indeed withdraws the full asset base from the contract, the underlying guarantees are reduced or in fact eliminated.
- (5) To the extent that the future payments associated with the guarantees must be characterized as a form of earnings, these earnings have been eliminated and such elimination has resulted in an impermissible forfeiture.

Again we would greatly appreciate any reaction to this summary to ensure that we can offer relevant comments.

We discussed during our meeting at your offices that life insurance investments within a DC Plan could already create a phenomenon that would be an impermissible forfeiture under the position summarized above where the face value of the insurance could create a net present value (NPV) that is significantly different / higher than the cash surrender value (CSV). One member company discussed this issue with their actuarial area and determined that the cash surrender value of a policy would not generally correlate to the actuarial value or net present value of the

policy for individuals. The underlying investment, premium payments and other factors can change the CSV. The real NPV of a policy would need to be determined based on the face value of the policy along with certain facts about the individual. For example, a terminally ill participant with a \$200,000 face value policy with a CSV of \$5,000 could arguably forfeit part of their value if the participant elected to transfer or receive the CSV instead of keeping the policy for his / her beneficiary.

Another possible example where an actual net present value could be different than the available benefit under the Plan is the return of premium death benefit option made available in the QLAC final regulations issued in July of 2014. Our understanding is that a QLAC could offer to a beneficiary either a life annuity option or a return of premium (less payments already made from the QLAC) without determining the NPV or actuarial value of the stream of income offered by the QLAC. There would certainly be examples where the actuarial value of the annuity payments could be higher than the return of premium death benefit.

Even though not under the control of Treasury, it has been recently widely published that many Americans often choose sub-optimal elections with their social security payments causing our social security system to often enable recipients to “forfeit” part of their value through imprudent benefit elections.<sup>i</sup>

#### Follow-Up Items

We plan to collect and to transmit to you under separate cover some additional information that relates to other topics we discussed, including: (i) information regarding how the guaranty fee is allocated among different product features; (ii) some analysis of the relative pros and cons of investing in fixed annuity products rather than GLWB’s taking into account the nature and timing of the investment (lump sum or periodic, pre-retirement or upon retirement, etc.) (As to this point we note parenthetically that as the member companies discussed this point, the analysis is more difficult than it appears. For example, if you consider that market conditions over the last seven years have been dominated by relatively low interest rates and higher equity markets, a participant who purchased a GMWB in 2009 instead of a deferred fixed annuity would likely be better off in the GMWB. On the other hand if the equity markets were in decline and interest rates were higher, then a fixed deferred annuity would provide more income. Additionally, GMWBs have risks, features and benefits that make a comparison to the income offered by a traditional fixed annuity somewhat uneven. The downside protection, ability to participate in higher markets, access to the market value of the underlying assets, and the ability to bequeath the remaining value upon death are features of the GMWB that would not generally be available to an income generating fixed annuity, making comparisons to a fixed annuity somewhat arbitrary), and (iii) information regarding market adoption rates for plans and participants that offer a GMWB. In this connection we note that LIMRA does gather information on GMWBs and has published some market data.<sup>ii</sup> LIMRA reports that 33,500 plans, with 71,300 participants

and over \$3.6 billion are invested in investments with a GMWB contract. For your convenience we have attached a summary copy of the LIMRA results. Even though GMWBs have proven to be the most viable guaranteed income solution in the DC market, the adoption still remains low (single digit adoption at both the plan and participant level). Clarity and support from treasury for this type of income feature could act as a catalyst for additional adoption within the DC marketplace.

Again, we are grateful for the opportunity to communicate our perspectives to you and would welcome future opportunities as the industry experience with these products evolves.

W.R.C.

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<sup>i</sup> See Innovative Strategies to help Maximize Social Security Benefits – Prudential Insurance 2014

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See In Plan Income Guarantee Availability and Election Tracking Survey as of December 2014.