

Closing the guarantee gap

How policymakers can restore the role of lifetime income in workplace retirement plans





TIAA started out nearly 100 years ago to help ensure teachers could retire with dignity. Today, the company is the leading provider of financial services in the academic, research, medical, cultural and government fields.

- TIAA has paid \$394 billion in benefits to retired participants since 1918.¹
- We paid \$4.8 billion in benefits to retired participants in 2016.²
- More than 31,000 annuitants over the age of 90 receive income from us today.³

Introduction

Retirement income planning, said noted economist William Sharpe, “is a really hard problem... the hardest problem I’ve ever looked at.”⁴ If a Nobel laureate like Sharpe finds this a difficult problem, imagine the plight of millions of Americans who receive little or no assistance at work in planning how to manage their spending in retirement! As longer lives heighten individuals’ challenges in financing their retirement, experts increasingly agree: Workplace plans that enable people to accumulate savings *for* retirement, such as the popular 401(k) plan, must also help people manage those savings *in* retirement. These experts concur that too many of these plans lack crucial design features that could *guarantee* income that lasts throughout retirement. One major concern is that many plans do not even offer lifetime income features like annuities, the traditional device for ensuring that retired Americans do not outlive their savings.

On the surface it may appear as if the shift from traditional pension plans, commonly referred to as defined benefit (DB) plans, to the modern pension design, commonly referred to as 401(k), 403(b), or defined contribution (DC) plans, is responsible for the risk Americans face of outliving their savings in retirement. But a closer examination reveals another source of risk: Many workers lack access to guaranteed lifetime income solutions through their DC plan. Fortunately for policymakers, reducing this risk is well within reach, as thoughtful plan design can provide workers with a long-accepted tool for converting their savings into a lifetime of income *without* needing to do the calculation that Sharpe himself found exceptionally difficult.

Ensuring that American retirees can count on sufficient income to last throughout their retirement is among the most critical issues facing our economy over the next 15 years as the wave of baby boomer retirements accelerates. What has become obvious is that today’s retirement savers need better plans—notably, plans that can produce a stream of income that is guaranteed to last a lifetime.



Today’s retirement savers need more plans that can produce a stream of income that lasts a lifetime.

We review 3 key issues



We document the important role that guaranteed lifetime income solutions play in ensuring a secure retirement



We describe how the current legal landscape creates incentives for employers to exclude such lifetime income solutions from workplace plans



We recommend specific policy changes that will restore the critical role of guaranteed lifetime income solutions in ensuring Americans will not outlive their retirement savings

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I. The importance of guaranteed lifetime income in retirement income

As with most developed countries, the population of the United States is aging. According to the Bureau of Labor Statistics, 800,000 Americans aged 65 or older without a disability retired in the fourth quarter of 2016 alone.⁵ By one estimate, the U.S. had close to 50 million retirees in 2014.⁶ With 10,000 baby boomers retiring each day, the total number of U.S. retirees will rise to over 66 million by 2025 and over 80 million by 2040.⁷

Longer life expectancy is a phenomenal societal achievement, but it also increases “longevity risk,” that is, the chance that retirees will outlive their savings. Many other developed countries have reformed their private retirement systems to reduce this risk. But the United States has yet to address this issue directly.⁸ Rather, our system continues to focus more on *accumulating* assets for retirement than on *preserving* assets in retirement.⁹ Central to addressing this challenge is to correct a critical flaw: Annuities—key investment vehicles for guaranteeing income in retirement—are largely missing from the U.S. private retirement system.

Longevity risk and retirement income planning

The goal of income planning is to ensure that retirees have adequate income for all of their lives. As the following table illustrates, Americans can now look forward to 20 to 30 years in retirement. Today, more than half of 65-year-old men will live beyond age 85 and one in three is expected to live to at least age 90. Life expectancy is even higher for women; nearly



Longer life expectancy increases “longevity risk,” that is, the chance that retirees will outlive their savings.

Table 1. Probabilities of length of retirement

| Years (at least) | Male | Female | Either | Both |
|------------------|------|--------|--------|------|
| 0 | 100% | 100% | 100% | 100% |
| 5 | 93% | 95% | 100% | 88% |
| 10 | 83% | 89% | 98% | 74% |
| 15 | 71% | 79% | 94% | 56% |
| 20 | 54% | 65% | 84% | 35% |
| 25 | 34% | 46% | 64% | 16% |
| 30 | 16% | 25% | 37% | 4% |
| 35 | 5% | 10% | 14% | 0% |
| 40 | 1% | 2% | 3% | 0% |

Most Americans underestimate their life expectancy... putting them at risk of outliving their savings



More than half of 65-year-old men will live beyond age 85 and one in three is expected to live to at least age 90.



Nearly two-thirds of 65-year-old women are expected to live to age 85 and almost half will live to age 90.¹⁰

Will they have enough income to last through retirement?

two-thirds of 65-year-old women are expected to live to age 85 and almost half will live to age 90. Taken together, in nearly two-thirds of married 65-year-olds, at least one spouse will live to age 90 and nearly 2 in 5 will live to 95.¹¹ Yet few Americans actually understand these relatively long life expectancies. Two-thirds of pre-retiree men underestimate the life expectancy of the average 65-year-old man—and among those who do, 42 percent underestimate average life expectancy by five years or more. Likewise, roughly half of pre-retiree females underestimate the life expectancy of the average 65-year-old woman.¹²

Not only do most Americans underestimate life expectancy, they also face a significant gap between the resources they *should have* to be financially secure in retirement and the resources they *do have*.¹³ Many Americans can immediately cite what they believe to be the value of their home and its associated mortgage. Similarly, most know the balance in their savings and retirement accounts, yet lack full understanding of how much money they'll need throughout their retirement. As a result, Americans cannot be sure whether their accumulated savings will be adequate to last through retirement.

Taken together, in nearly two-thirds of married 65-year-olds, at least one spouse will live to age 90 and nearly 2 in 5 will live to 95.¹⁴

And unfortunately, for many their savings will not be adequate. One recent study quantifies a “Retirement Income Deficit”—the difference between what retirees ought to have saved and what they *actually* have saved—of \$7.7 trillion. Another, using different data and methodology, estimates the shortfall to be over \$4 trillion.¹⁵ Regardless of how the gap is quantified, increased longevity is a significant contributor to the shortfall. For many baby boomers and Gen-Xers, the “prospect of ‘out-living’ ... their retirement wealth is a very real risk,” especially for those without some income in retirement that is guaranteed for life.¹⁶

Guaranteed lifetime income protects against longevity risk and poverty in old age

The marketplace has long offered a solution to the challenge of longevity risk: the annuity. An annuity is an insurance product that guarantees the payment of a stream of income for either a stated duration (20 years) or a lifetime (until death).

In an annuity's traditional form, the “**fixed annuity**,” an individual pays premiums to a life insurance company, either as a single payment or over time, and receives a promise of a guaranteed stream of payments, usually for life. Payments can begin either immediately (a single premium immediate annuity) or at some future date (a deferred annuity). In this form of annuity, the insurance company assumes the risk of making the promised payments.

In the other major form of annuity, the “**variable annuity**,” individuals decide how their contributions will be invested among the various funds offered by the insurance company. Both the risk that their investments will do poorly and the reward if they do well remain with individuals, not the insurance company. Investors in a variable annuity generally have the right, but not the obligation, to convert their account accumulations into a stream of payments guaranteed by the insurance company. Investors also may elect distributions either from time to time or through a systematic withdrawal strategy.

Fixed annuity

A contract between an individual and an insurance company that guarantees periodic payments to the individual or designated beneficiary in return for an investment. In a fixed annuity, payment amounts either do not change or they change at stated intervals.

Variable annuity

A type of insurance contract having a value that changes based on an underlying investment portfolio (which may include mutual funds) or based on a performance index. Funds held in the annuity accumulate on a tax-deferred basis.

Any guarantees are subject to the issuer's claims-paying ability. Payments from variable annuities will rise or fall based on investment performance.

While investors not opting for a guaranteed stream of payments continue to receive the benefit of any investment increases, their funds also remain exposed to the risk of loss during an economic downturn, interest rate changes, and/or market volatility. Some insurance companies, however, now offer “riders” to variable annuity contracts, which (for a fee) can provide investors with lifetime withdrawal benefits that guarantee a minimum floor of income, independent of market performance.¹⁷

The U.S. lags on guaranteed lifetime income



Many developed countries have reformed private retirement savings systems to help ensure retirees build lifetime income streams—so they don't outlive their savings in retirement.

It's time the U.S. took steps to do so, too.

Individuals are free to choose how they structure both traditional and variable annuities. For example:

- annuities can cover the lives of an individual and a beneficiary such as a spouse so that payments continue to the survivor for life; and
- many annuities offer a guarantee of a minimum number of payments, for example, for a 10-year period.

In most cases, an annuity will pay a fixed monthly amount, but some insurance companies also may offer an inflation-adjusted annuity that increases monthly payments in line with cost-of-living increases. Others may offer an annuity whose initially fixed monthly payments may rise over time in line with increases in a market index such as the S&P 500 index.

Retirement savings and guaranteed lifetime income products

Among economists, there is a consensus that lifetime income solutions in the form of annuities offer exceptional protection against retirees outliving their savings. One analysis of outcomes comparing annuities to other popular retirement financing strategies without an annuity component found that “even when the retirees chose the portfolio that minimized the probability of running out of money while still alive, the retirees still faced nearly a one-in-five chance of failing to sustain this level of income.”¹⁸ Moreover:

[F]or any given level of guaranteed monthly income for life, the annuity provides this income at lower cost than any other product. It is for this reason that a large number of academic studies by economists have shown that annuities have a very important role in the portfolios of most retired individuals. Indeed, numerous studies have shown that having access to life annuities is equivalent to a significant increase in wealth.¹⁹

Retail annuity

An annuity sold in the open marketplace, available to anyone.

In-plan annuity

An annuity offered to employees through a workplace retirement plan.

Annuities give you regular income after you retire



Annuities are investment vehicles that guarantee the payment of a stream of income in retirement.

Experts agree: They offer exceptional protection against outliving your savings.

As with any other investment product, fees and costs can substantially diminish the value an investor receives from an annuity.

One key determinant of value is whether the investor purchases a “**retail**” or “**in-plan**” annuity. Retail annuities are sold by financial advisors on an individual basis directly to investors. The retail annuity industry has been criticized for its high fees, excessive surrender charges, and abusive commission-based sales practices.²⁰

Alternatively, many retirement savers purchase in-plan annuities through their workplace retirement plan. In some plans, such as in the public K-12 education market, workers can purchase *individual* in-plan annuities. These broker-sold annuities also have been criticized recently for having high fees and charges.²¹ More commonly, in-plan annuities are sold on a *group* basis.²² Because they are typically not sold on commission, these annuities can cost far less than individual annuities, both retail and in-plan.



If their retirement savings plan permits, participants can purchase an in-plan annuity over time with payouts deferred to a later date. Research has shown that:

Permitting a deferred annuity...into the set of investment options available in retirement savings plans...improves the overall financial performance of a retirement savings plan... This comes about because, in a retirement savings program, the deferred annuity can be invested prudently in longer dated, more illiquid, higher yielding underlying securities than money market and short-term fixed income alternatives.²³

The availability of **deferred, in-plan annuities** can enable participants to receive substantially higher payments than those offered through an immediate annuity at retirement. In particular, deferred, in-plan annuities can offer important protection against “interest-rate risk.” Interest rates are an important factor in determining how much income an annuity will provide. Insurance companies can offer higher payouts when rates are high because actuarial assumptions are that the insurer can earn more on the premiums paid. Because interest rates can vary significantly over a work life,

participants purchasing a deferred in-plan annuity benefit during periods when higher rates occur. These retirement savers also avoid the risk in purchasing an immediate annuity at retirement when prevailing interest rates—and consequently annuity payments—might be low.

Financial analysis shows the financial benefits to participants of including in-plan annuities—whether immediate or deferred—as investment options in workplace retirement plans. Yet, as we explore in the next section, relatively few workplace plans offer participants the opportunity to invest in in-plan annuities.

Deferred, in-plan annuity

An annuity purchased with retirement-plan contributions that is not yet paying income because it is still in the accumulating or pre-retirement stage, which means money is accumulating on a tax-deferred basis.

Annuities do not provide any additional tax-deferral advantage over other types of investments within a qualified plan.



In 2015, average monthly Social Security payments (\$1,348) replaced only some 30 to 50 percent of pre-retirement income.

II. Annuities: Missing in action for many in today's retirement savings system

Most retired Americans are familiar with the concept of annuities because they receive a traditional annuity through Social Security. For many, Social Security is their primary—and often sole—source of guaranteed retirement income. But while financial planners typically suggest that retirees need at least 70 percent of their pre-retirement income for a comfortable retirement, Social Security provides only a floor of income.²⁴

The U.S. private retirement system is intended to help Americans accumulate financial resources beyond Social Security for retirement. Employers are encouraged to offer workplace retirement plans to their workforce, and plans receive favorable treatment in the tax code. As Table 2 shows, it is a large system. In 2014, according to Department of Labor (DOL) figures, private employer-sponsored workplace retirement plans alone covered about 90 million active participants (14.5 million in DB plans and 75.4 million in DC plans) and over 40 million retired or formerly employed participants (23 million in DB and 19 million in DC plans).²⁵ The assets held in workplace retirement plans sponsored by both private and government employers (DB and DC plans) or held by individuals in individual retirement accounts (IRA) play an important role in the U.S. economy. In 2016, they accounted for over \$23 trillion in financial assets.²⁶ DC plans and IRAs, which are largely funded through rollovers from workplace plans, hold the bulk of these assets.

Over the past 25 years, DC plans that enable employees to save in the workplace have become the growth engine of the U.S. retirement system. There are two primary types of workplace retirement plans: (1) 401(k) plans that any private-sector employer may sponsor; and (2) 403(b) plans available to only certain tax-exempt or public education organizations.²⁷

While financial planners typically suggest that retirees need at least 70 percent of their pre-retirement income for a comfortable retirement, Social Security provides only a floor of income.

Table 2: Snapshot of the U.S. retirement system²⁸

Coverage of private workplace retirement plans



89.9 million active participants in 640,000 plans

- **14.5 million** participate in defined benefit plans
- **75.4 million** participate in defined contribution plans, including **62.7 million** in retirement savings plans

Worker participation in a workplace retirement plan



Private industry

Participate  48%

State and local government

Participate  81%

Assets held in workplace retirement plans totaled \$15.4 trillion at the end of 2016



- **\$7 trillion** in defined contribution plans, including
 - **\$4.8 trillion** held in 401(k) plans
 - **\$900 billion** held in 403(b) plans
- **\$2.9 trillion** in private-sector defined benefit plans
- **\$3.9 trillion** in state and local government defined benefit plans
- **\$1.6 trillion** in federal government defined benefit plans

Table 3 describes some of the important similarities and differences between 401(k) and 403(b) plans. As more fully explained below, the histories of the 401(k) plan and the 403(b) plan are very different. The 401(k) plan slowly evolved out of prior plan designs, largely intended to provide supplemental retirement savings for employees of private corporations, to become the predominant workplace retirement plan for corporate employers only in the last 25 years. The 403(b) plan, in contrast, was designed a century ago to provide annuity income to professors in retirement. It still retains many of its original features. In the last 10 years, 401(k) and 403(b) plans have become more similar in terms of how they are treated under both the tax code and the Employee Retirement Income Security Act of 1974 (ERISA). In the 403(b) universe, however, there remain important differences in how the two types of plans are treated under ERISA.²⁹

Many agree that today’s system needs significant improvement to close three key gaps. In two, the **coverage gap** and the **savings gap**, policymakers are implementing new

Policymakers should leverage the 403(b) model’s proven ability to provide guaranteed lifetime income.

strategies. In the third, the **guarantee gap**, there has yet to emerge policy or regulatory consensus on reform.

The coverage gap

The U.S. retirement savings system is a voluntary system that, through tax incentives, encourages employers to offer workplace plans and employees to contribute to them. The coverage gap refers to the fact that many employees work for an employer not offering a workplace plan. The Government Accountability Office (GAO) recently reported that only about half of private sector workers—especially those who are low-income or employed by small firms—have access to a workplace retirement savings program.³⁰ Yet one of the most important factors in determining financial

The U.S. retirement saving system has 3 major shortcomings



Coverage gap

Not enough Americans have access to a plan



Savings gap

Americans aren’t saving enough



Guarantee gap

Americans aren’t managing their savings after they retire to ensure they don’t run out money

Policymakers are focused on addressing the first two. It is time also to develop a consensus on solving the “guarantee gap.”

Table 3. Key distinctions between 401(k) and 403(b) plans

| | 401(k) plan | 403(b) plan¹ |
|--|--|--|
| Original purpose | Enable employees to share in profits of their employer on a tax-deferred basis | Provide retirement income to professors through tax-deferred annuities |
| Governing law | Tax law and ERISA | Same as 401(k) plan |
| Eligible employer | Any employer except a state or local government but some governmental 401(k) plans are grandfathered through the Tax Reform Act of 1986 | A tax-exempt 501(c)(3) employer such as a charity or a private or public educational organization, hospital or church |
| Eligible employees | Employer chooses, subject to tax rules on not favoring high-paid employees | Same as 401(k) plan for employer contributions; if one employee can contribute, all employees working more than 20 hours per week are eligible under a universal availability rule |
| Employer contributions | Discretionary or fixed, across-the-board and/or matching, must not favor high-paid employees | Same as 401(k) plan |
| Employee contributions | Up to \$18,000 (+\$6,000 if age 50 or over) in 2017, can be limited if overall contributions favor high-paid employees | Up to \$18,000 (+\$6,000 if age 50 or over) in 2017. Also includes a special 15-years of service catch-up rule |
| Permitted investments | Employer sets the menu; it can include mutual funds, annuities, other insurance or investment company products, and individual stocks and bonds bought through brokerage windows | Limited by law to annuity contracts or custodial accounts invested with registered investment companies Employees choose from one or more vendors made available by employer |
| Annuities available | Rarely | Routinely |
| Assets held | A trust or an annuity contract used in lieu of a trust supervised by a fiduciary who holds title to the investments in each employee's account | Plan offers either group or individual annuity contracts or custodial mutual funds. Employees may own their contracts and/or accounts |
| Vesting rules | Employer sets vesting schedule for employer contributions; employee contributions always fully vested | Same as 401(k) plan |
| Employer administrative involvement | Employer and other fiduciaries are responsible for managing the plan and its investments under ERISA rules | Same as 401(k) plan |

1. Tax law also permits a special 403(b) plan limited to employee contributions. These 403(b)s are not subject to ERISA. See the text for more information about these plans.

readiness for retirement is the ability to save for retirement at work. For example, a recent study found that access to a plan among Gen-Xers *doubled* retirement readiness among those in the lowest income quartiles and significantly increased readiness for those in other income brackets.³¹

Many policy initiatives have been proposed to help solve the coverage gap. At the federal level, there is interest in

expanding the use of payroll-deduction IRAs in the workplace as a substitute for a workplace plan and also in enabling multiple employers to offer a plan collaboratively without each having to assume full responsibility for managing it. So, too, are states innovating, and Oregon became the first to create a state-managed workplace retirement plan invested in federally regulated IRAs for private sector workers.

The savings gap

The savings gap refers to the fact that, even if they have access to a plan at work, many workers are not saving enough in these plans to ensure a financially secure retirement. Estimates of the risk of a shortfall in retirement savings vary substantially depending on the study sample, assumptions, and type of analysis. After a review of the major studies, the GAO concluded that “about one-third to two-thirds of workers are at risk” of being unable to maintain their pre-retirement standard of living in retirement.³² The problem is particularly acute among workers on the cusp of retirement. According to the GAO:

Among households age 55 and older, about 29 percent have neither retirement savings nor a DB plan, which typically provides a monthly payment for life. Households that have retirement savings generally have other resources to draw on, such as non-retirement savings and DB plans. Among those with some retirement savings, the median amount of those savings is about \$104,000 for households age 55–64 and \$148,000 for households age 65–74, equivalent to an inflation-protected annuity of \$310 and \$649 per month, respectively. Social Security provides most of the income for about half of households age 65 and older.³³

Addressing the savings gap requires raising the amount that employees, and, optimally, employers contribute to a plan over time. In employer-sponsored 403(b) plans and 401(k) plans, employers decide whether they will contribute and,

The retirement income gap is staggering



The difference between what retirees ought to have saved and what they actually have saved is estimated to be between

\$4 to \$7.7 trillion³⁴

if so, choose whether they will contribute to all participants (“across-the-board contributions”) or only to those who contribute themselves (“matching contributions”).

In recent years, policy initiatives in plan design have focused exclusively on *asset accumulation*—that is, making it easier for workers to participate in workplace retirement plans. As a result especially of legislation Congress enacted in 2006, a growing number of employers now feature “auto-enrollment” plans in which workers are automatically enrolled to save through payroll deduction unless they opt-out. Recognizing that initial rates of saving under auto-enrollment may not be sufficient for accumulating substantial assets for retirement, some employers also have adopted “auto-escalation” features so that worker contributions are increased annually unless they opt-out. These efforts to make saving more automatic can be expected to reduce the savings gap significantly in the future.

The guarantee gap

Alongside the coverage and savings gap is the guarantee gap, which reflects the growing appreciation that most workplace retirement plans are short-sighted. As baby boomers retire, many with substantial retirement assets, their workplace plans often provide them with few resources to help them make their savings last for the potential 20 to 30 years of retirement. Research reported in a recent GAO study of distribution options in 401(k) plans found that many such plans require participants to withdraw their savings *entirely* before age 70½.³⁵ Less than one-third of large- and mid-size plans offer flexible withdrawal options—and even among those, few offer income guarantees.³⁶

The GAO findings are confirmed by retirement industry studies. For example, one recent survey reported that among 401(k) plans, a mere 1 in 20 (*i.e.*, 5 percent) offers participants access to a lifetime income option.³⁷ And while employers are increasingly adding features to their 401(k) plans to help employees manage their savings in retirement, these features generally do not include options that provide guaranteed income. For example, another survey of almost 200 mid- and large-sized employers found that the most prevalent lifetime income solutions were:

- systematic withdrawals (73 percent of employers);
- income planning tools (64 percent); and
- education (60 percent).³⁸

In a similar survey of 250 large employers (whose plans collectively cover seven million participants), 45 percent offer systematic withdrawal options, 66 percent offer planning tools, and some 30 percent offer managed account services with drawdown features. The absence of lifetime income options that offer a guarantee is striking.³⁹

Many 403(b) plans retain their historic focus on generating retirement income by offering both fixed and variable annuities. In 2012, 84 percent of employer-sponsored 403(b) plans offered fixed annuities as an investment option.

In contrast to 401(k) plans, many 403(b) plans retain their historic focus on generating retirement income by offering both fixed and variable annuities. In 2012, 84 percent of employer-sponsored 403(b) plans offered fixed annuities as an investment option. Fixed annuities were featured in both large and small 403(b) plans. For example, 65 percent of the smallest plans (less than \$1 million in assets) offered these annuities, and that percentage increased steadily with plan size with 95 percent of the largest plans (more than \$1 billion in assets) offering them. The same trend is apparent in the percentage of plan assets held in fixed annuities. Overall, 26 percent of 403(b) plan assets were held in fixed annuities. In addition, variable annuities accounted for 27 percent of 403(b) plan assets.⁴⁰

But where annuities are not available or chosen, the guarantee gap sets plan savers adrift at retirement without the ability to choose payment options that provide guaranteed lifetime income. This gap also has significant consequences for society. As economists point out:

More annuitization is likely to reduce old-age poverty and increase retirement satisfaction. Put differently, old-age poverty may be expected to rise and retirement satisfaction to deteriorate because of large-scale deannuitization...[in retirement savings plans] in the United States. Wider adoption of annuitization may offer a way to counter those adverse consequences while preserving employers' ability to manage pension benefit costs.⁴¹

Understanding how to solve this problem first requires understanding how it began.

The origins of the guarantee gap

Many point to the long secular decline in DB plans to explain why so few plan participants have access to annuities today. DB plans have long been required to pay benefits as an annuity, unless a participant chooses a different option with spousal consent. And, until very recently, most DB plans did not offer any other form of benefit besides annuities. In the last 30 years, however, as DOL statistics document, private-sector employers have shifted away from offering DB plans. In 1980, there were about 150,000 DB plans covering some 30 million workers. In 2010, only about 45,000 plans remained, and they covered about 17 million active workers.⁴²

It is true that DB plans had been a prominent source of guaranteed income in retirement supplementing Social Security benefits. But DB plans have never been the only source of guaranteed lifetime income in workplace plans. In reality, the private retirement system is not neatly divided into two parts: DB plans that are required to provide annuities; and DC plans that are not. Rather, three significant policy changes affecting annuities over the past 25 years—one in tax law and two in pension policy—have created substantial disincentives for employers to provide DC plans with annuities.

A tax law change and its consequences for plan design

In 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) made a change to tax law that immediately had an adverse effect on in-plan annuities. To qualify for special tax benefits, a workplace retirement plan must comply with tax code rules, which define a pension plan as one designed “to provide for the livelihood of ... employees ... after the retirement of such employees through the payment of benefits...”⁴³ By law, plans defined to be pension plans must include annuities to pay benefits in retirement. The DB plan is one familiar example of a pension plan because it is required to provide retirement income in the form of annuities. It is almost forgotten now, but tax laws also classify a once-popular DC plan—the **money purchase plan**—as a pension plan. In a money purchase plan, employers contribute a set

amount each year to participants’ accounts. At retirement, if not before, account accumulations are used to fund annuities. Pre-tax employee contributions are not permitted.

Early on, the DC system also permitted corporate employers to offer a supplemental plan called a **profit-sharing plan**, originally intended as a bonus pay plan, rather than as a workplace retirement plan.⁴⁴ Employers with profits could make tax-deferred contributions to participant accounts. Because profit-sharing plans are not classified as pension plans, tax law does not require them to include annuities if they meet other legal criteria. Also in the earlier years, employers who wanted to give their employees an opportunity to save for retirement offered a “thrift” plan limited to after-tax contributions. By the 1980s, however, profit-sharing plans no longer required profits for employer contributions. In addition, Section 401(k), as a feature in a profit-sharing plan, was added to the tax code, allowing participants and employers to make pre-tax contributions, thus making thrift plans obsolete. The result was the creation of the now ubiquitous 401(k) plan.

Perhaps the 401(k) plan wouldn’t have become so popular without a major change in tax policy that had unintended consequences. For decades, tax law had strongly favored the money purchase plan over the profit-sharing plan. Whereas corporate employers could deduct contributions to a money purchase plan of up to 25 percent of the total compensation

Money purchase plan

A DC plan that employers and (rarely) employees pay into with a required, fixed contribution rate (i.e., contributions are not subject to employer and employee discretion like a profit-sharing plan). Contributions are usually calculated as a percentage of the participant’s compensation. The default benefit in money purchase plans, like DB plans, must be a life annuity—meaning that after retiring individuals will receive regular income payments throughout their lifetime.

Profit-sharing plan

A DC plan such as a 401(k) plan where both employer and employee contributions are discretionary (not fixed). Only a small fraction of profit-sharing plans offer a life annuity form of retirement benefit.



paid to participants, they could only deduct up to 15 percent for profit-sharing plan contributions. To capture the maximum deduction while also enabling employees to contribute to a workplace retirement plan, employers had often sponsored both a primary money purchase plan and a supplemental profit-sharing plan. In 2001, however, EGTRRA equalized the deduction limit for both types of plans at 25 percent of compensation.

Almost immediately after the new rules gave 401(k) plans an equivalent income tax deduction, corporate employers abandoned money purchase plans for 401(k) profit-sharing plans. Employers appreciated the flexibility of the profit-sharing plan design where they no longer had to make fixed, annual contributions. Instead, employers could decide whether and how much to contribute each year. They also could operate just one plan to achieve maximum tax deductions. The IRS itself facilitated this flight—from money purchase plans with annuity features to 401(k) plans without required annuities—by issuing guidance explaining how a money purchase plan could be converted or merged into a profit-sharing plan.⁴⁵

Among non-profit employers with a 403(b) plan, no such shift away from plans with annuities occurred. In part, this was because tax deductions tend not to matter to non-profit employers. More significant, however, is that annuities have always been an integral feature of the 403(b) plan. In 1918, with the sponsorship of Andrew Carnegie, TIAA was created to provide college professors with retirement income through employment-based annuities. The annuities sold by TIAA became the model for the tax-deferred annuities that form the basis of Section 403(b) of the tax code, with mutual-fund investments also permitted beginning in 1974.

Today, employers that offer 403(b) plans continue to view them as key vehicles for securing their employees' welfare in retirement, and annuities remain a core investment option.⁴⁶ And 403(b) participant interest in purchasing annuities remains strong. Industry statistics indicate that in 2014, fixed annuities accounted for 43 percent of the 403(b) market, variable annuities 33 percent, and mutual funds 24 percent. Moreover, investments in fixed annuities grew from \$350 billion in 2010 to over \$460 billion in 2014, and in variable annuities from \$240 billion in 2010 to over \$350 billion in 2014.⁴⁷

Fiduciary law changes and the consequences for annuity availability

Two other policy changes have had a more gradual but perhaps even more significant effect on the availability of annuities in 401(k) plans. Over the past 25 years, changes to ERISA have made the legal climate for employers whose plans offer annuities more complex. Annuities can pose significant legal risks in the view of many legal and other advisors who routinely counsel their clients not to add annuities to their plans to protect them against future lawsuits—and employers have listened. Very recent survey data indicate that about 40 percent of employers cite fiduciary exposure as their top concern about adding guaranteed income products to their plans.⁴⁸

Employers that offer 403(b) plans continue to view them as key vehicles for securing their employees' welfare in retirement.

These legal risks arise from the strict standards of behavior that ERISA imposes on plan sponsors and others who act on behalf of workplace plans. In both 401(k) and employer-sponsored 403(b) plans, the selection of investment options is a fiduciary act under ERISA.⁴⁹ Under Section 404 of ERISA, plan fiduciaries:

- must consider only the interests of participants when acting on behalf of the plan;
- must act for the exclusive purpose of providing benefits and/or defraying plan expenses;
- are subject to the “prudent man” rule, which requires fiduciaries to make a proper investigation before making an “informed and reasoned” decision;
- can be held personally liable if they are found to have breached their duties to a plan or knowingly participated in a breach by another fiduciary; and
- can be subject to excise taxes under the tax code, civil and criminal penalties under ERISA, and monetary damages from litigation.⁵⁰



Fiduciary issues in selecting an annuity provider

After the failure of a large insurance company in the early 1990s affected former DB plan participants, legal risks associated with offering annuities in a retirement savings plan multiplied. In 1993, the Pension Annuitants Protection Act amended ERISA to impose additional liability on fiduciaries related to annuities in both DB and DC plans.⁵¹ Interpreting this legislation, in 1995 the DOL issued new rules imposing very strict standards for the process that fiduciaries should follow when selecting an annuity provider.⁵² The most controversial requirement was that fiduciaries should select the “safest possible” annuity.

In the Pension Protection Act of 2006 (PPA), Congress eliminated the “safest possible” standard for DC plans. In 2008, the DOL issued final regulations replacing the “safest possible” annuity standard with a “safe-harbor” process for fiduciaries to follow when selecting an annuity provider.⁵³ If fiduciaries follow this process, they satisfy the “prudent man” rule (at least in terms of annuity provider selection). Even though the safe-harbor process is not the exclusive means by which fiduciaries can satisfy ERISA’s fiduciary rules, employers tend to view safe harbors as critically important to reducing their potential fiduciary liability.

Unfortunately, the safe-harbor regulations have failed to satisfy the legal and the employer communities. The regulation’s safe-harbor process is ambiguous, complex, expensive and challenging to follow for plans with fewer resources. A key sticking point is how fiduciaries should assess the insurer’s financial ability to pay promised benefits far into the future. Plan sponsors fear that if an annuity provider fails years later, the plan sponsor will inadvertently become the insurer of last resort.

In response to requests from the financial-services industry and employers, the DOL released additional guidance in 2015 defining some key terms in the safe-harbor process and explaining when fiduciary liability does and does not apply.⁵⁴ Some practitioners believe this recent guidance will improve their plan sponsors’ ability to select a provider of annuities and other lifetime income products.⁵⁵ But others in the legal community remain more cautious. Without more explicit guidance, it is likely, as the GAO noted in its recent analysis of why so many workplace plans don’t offer annuities, that “concerns about legal risks ... may deter many plan sponsors—typically employers that provide 401(k) plans and establish investment and distribution options—from offering lifetime income options” such as annuities.⁵⁶

Fiduciary issues in selecting the investment menu

Just as this earlier policy change pulled employers away from annuities, a later one pushed them toward annuity-free types of investments. Under ERISA, plan fiduciaries are responsible for choosing the investment menu offered to participants. But under ERISA Section 404(c), if a plan permits participants to choose how their accounts are invested within that menu, then plan fiduciaries are not liable for any losses suffered by investments. Regulations issued in 1992 under ERISA Section 404(c) set general standards for the types of investment alternatives, the investment process, and the types of information that must be available to participants. If a plan satisfies those standards, then participants are “deemed to have exercised control” over their accounts, thus releasing plan fiduciaries from liability for poor investment outcomes.

Employers have increasingly embraced this 404(c) relief from fiduciary liability. While 74 percent of the workplace retirement plans filing annual reports in 1999 allowed participants full investment discretion, 6 percent allowed partial investment discretion, and only 19 percent allowed no investment discretion. By 2014, those figures were 88 percent, 3 percent, and 9 percent, respectively.⁵⁷

As policy changes intended to help solve the savings gap were proposed as part of the PPA, Section 404(c) relief came into question. One goal of PPA was to increase retirement savings by encouraging employees to contribute automatically through payroll deduction, unless they opted-out. Employers did not want to take on fiduciary liability for a class of investments that employers believed few participants would ultimately choose. To address this problem, PPA expanded Section 404(c) relief by creating a new concept for plan investment options—Qualified Default Investment Alternatives (QDIA). If participants failed to choose investments, an employer could default contributions into a QDIA and be insulated from legal liability.⁵⁸

In PPA, Congress directed the DOL to issue regulations defining QDIAs, requiring such default investments to “include a mix of asset classes consistent with capital preservation or long-term capital appreciation or both.”⁵⁹ The final regulations issued late in 2007 contained three categories of QDIAs: age-based funds such as target-date funds; risk-based investments such as a balanced fund; and individual professionally managed accounts. Despite Congress’ endorsement of capital preservation as an investment criterion, the DOL did not create a QDIA for money market funds, stable value funds, or guaranteed interest contracts.⁶⁰ (A participant can be defaulted into such a capital preservation-based fund but for only the first 120 days of participation.)

The current regulations also require that participants defaulted into a QDIA must have the ability to transfer out of it “no less frequently than once within any three-month period.”⁶¹ The QDIA regulations are based upon the original ERISA Section 404(c) regulations, which relieve plan fiduciaries of liability when participants select investments for their own accounts. The 90-day transferability rule is not required by statute. Rather, it was created by the DOL under its rule-making authority. DOL’s original rationale was to



protect participants against “the market volatility to which the investment alternative may reasonably be expected to be subject to,” and only applies to the three core investment alternatives offered by the plan, as defined in the Section 404(c) regulations.⁶² Yet the final QDIA regulations broadened the 90-day rule to all QDIAs, independent of their exposure to market volatility.

This 90-day rule has proven a considerable barrier to annuity products. In order to pay promised income to purchasers, insurance companies have a long-term investment horizon. Their investment portfolios also must satisfy state law reserve requirements and laws that direct how an insurer can invest premiums. As a result, the 90-day transferability rule is impracticable for many investment options offering lifetime income guarantees. And, from the perspective of protecting participants from market volatility, the 90-day transferability rule could be viewed as overly broad because capital preservation products, including annuities, have built-in protection from market volatility.

The DOL’s action was premised on a belief that investment funds with capital preservation characteristics, over the long-run, would not produce the rates of investment return necessary for adequate retirement savings.⁶³ Simply by defining the types of funds that qualify as QDIAs, however, the DOL created a strong incentive for employers to feature such funds prominently in their investment menus and not just for default contributions. Moreover, mere inclusion in the menu may cause participants who actively choose their investments to “interpret the selection of a QDIA as an implicit endorsement of that investment.”⁶⁴

Nearly a decade later, it's clear that target-date funds are the prime beneficiary of the QDIA regulations. One 2014 survey of plan sponsors reports that over 80 percent of plans use QDIAs, and the most popular QDIA is the target-date fund, available in three-quarters of those plans.⁶⁵ In the 401(k) market in 2014, the Investment Company Institute reports that 72 percent of 401(k) plan menus included target-date funds, and 48 percent of participants held at least some of their assets in them.⁶⁶

The DOL has identified “the need for lifetime income as an important public policy issue.”

QDIAs have changed the investment landscape for workplace retirement plans to the detriment of annuities. Most significantly affected is the traditional annuity for two reasons: (1) the requirement that a QDIA must be an investment portfolio in the form of a target-date type fund, a professionally-managed account, or a balanced fund; and (2) the 90-day transferability requirement. And variable annuity contracts could potentially qualify as QDIAs under today's regulations—but only if they allow participants to transfer out within any three-month period.

As federal regulators increasingly appreciate the need for in-plan lifetime income, they are reconsidering ways to include annuities and similar options in retirement plans. For example, in 2014, the DOL and U.S. Department of the Treasury issued new guidance allowing a target-date fund to include unallocated deferred annuity contracts within the target-date investment portfolio.⁶⁷ A key requirement is that the plan sponsor must choose the target-date fund and its investment manager, and, in turn, the investment manager must act as the fiduciary and choose the insurer providing the annuity contract. The investment manager and the insurer

must be independent of each other. This solves the insurer-selection problem for plan sponsors by transferring liability to investment managers willing to assume such responsibility.

More recently, the DOL has emphasized that an employer could prudently default participant contributions into an investment option that is not a QDIA. In other words, the QDIA safe harbor is not the water's edge for fiduciary prudence. TIAA had requested this guidance on a target-date fund offering that includes a fixed guaranteed annuity.⁶⁸ As participants age, these funds increase the allocation, capped at 50 percent, of their accounts to the annuity. Participants may transfer out of the annuity component for 12 months after the initial investment; thereafter, the annuity component has delayed liquidity. The DOL held that an investment option with such lifetime income options could be a prudent default investment option, even if it did not comply with the QDIA 90-day transferability requirement.

In its guidance, the DOL identified “the need for lifetime income as an important public policy issue” and emphasized its support for initiatives “that could lead to broader use of lifetime income options in defined contribution plans as a supplement to and enhancement of accumulation of retirement savings.” As a further step, the DOL also recently announced it will issue a Request for Information about the feasibility of incorporating lifetime income features into its QDIA regulations.⁶⁹

As we have seen, for the U.S. workplace retirement plans system to mature into the strong safety net that an aging society requires, it must be able to deliver guaranteed lifetime income to plan participants. This means giving financial instruments uniquely qualified to guarantee income in retirement a prominent role in workplace plans. It is too late now to bring back the money purchase plan; its design has become obsolete. What can and should be done is to remove impediments to annuity adoption by employers and to provide incentives for annuity selection by employees. This is the logical next step in the evolution of the modern workplace retirement plan.



III. The way forward

No single policy change will solve the guarantee gap, which is the product of a complex cycle involving federal policymakers, employers, and employees. Absent clearer regulations insulating plan sponsors from lawsuits, employers will continue to feel reluctance to add annuities to their plans. And without annuities as investment options in their plans, employees are unfamiliar with the benefits of annuities—and are unlikely to ask employers to add annuities as investment options on retirement plan menus.

There is an obvious solution to the guarantee gap: in-plan annuities must play a central role in retirement savings plans. Adding financial education, income planning tools, and more flexible distribution options are perhaps good first steps toward a more robust retirement savings plan design. But that is all they are—first steps. For the past decade, pension regulators have focused on making 403(b) plans look and operate more like 401(k) plans. To solve the guarantee gap, however, it will be necessary to incorporate the strengths of the 403(b) model in generating lifetime income into all retirement savings plans. These strengths are found in the core principles of 403(b) plan design, originally developed by TIAA, that provides savers:

- a plan that focuses on retirement income rather than wealth accumulation;
- investment options that focus on capital accumulation *and* preservation;
- deferred annuity investment options that build guaranteed retirement income over time;
- distribution options that offer immediate or deferred guaranteed income in retirement;
- education about how savings are transformed into lifetime income; and
- access to unbiased and objective investment advice.⁷⁰

With these principles in mind, and drawing on our experience as a leading provider of in-plan lifetime income solutions for nearly 100 years, TIAA offers the following six policy recommendations to policymakers. By changing federal policy in several key areas, these proposals promise to advance the presence of lifetime income in workplace retirement plans.



Policymakers can play a key role in closing the guarantee gap.

6 policy measures to help solve the retirement savings “guarantee gap” problem

For Employers

1. Simplify the safe harbor for selecting an annuity provider
2. Increase the portability of annuity contracts
3. Broaden the QDIA regulations to further accommodate lifetime income features as a default choice

For Employees

4. Provide an annual lifetime income statement to plan participants
5. Give participants more access to flexible income distribution options
6. Provide a tax incentive in retirement for those who annuitize



A key uncertainty has been the appropriate process that fiduciaries should follow when evaluating the financial strength of a potential provider. Insurance companies and products are licensed and regulated by state law. Although they often adopt model laws, states frequently differ in how they regulate insurance companies. Alongside this lack of a single centralized regulator, there is no centralized marketplace for insurance products that provides standardized comparative information. Thus, evaluating the financial strength of any given annuity provider can be a complex and uncertain process. Particularly for smaller employers who often lack the resources of in-house staff or outside consultants to perform independent analyses, the assessment process can be especially daunting.

For Employers

Overcoming resistance to offering annuities

Proposal 1: Simplify the safe harbor for selecting an annuity provider to allow fiduciaries to rely on standardized financial representations by insurers

Challenge: Out of uncertainty about how to satisfy fiduciary duties in selecting an annuity provider, employers have been reluctant to offer annuities on plan menus. Despite steps by DOL to clarify the current safe harbor under ERISA Section 404(a), many employers—and their legal counsel—have signaled the need for more certainty in the safe harbor’s terms.

Solution: The safe harbor should be simplified by permitting fiduciaries to rely on standardized information, generated through the process of state examination and licensing, about the financial strength of an insurer. The Retirement Enhancement and Savings Act of 2016 (RESA) offers such a solution.⁷¹ RESA would amend ERISA to allow fiduciaries to rely upon an insurer’s representations that it:

- is licensed to offer guaranteed retirement income contracts;
- for the current and preceding seven years, has operated under a valid certificate of authority from its home state, has filed audited financial statements, and maintains the reserves required by state law;
- will undergo a financial examination at least every five years in its home state; and
- will notify the fiduciary of any change in circumstances.

Assuming they otherwise satisfy the requirements of the safe harbor, plan-sponsor fiduciaries would be insulated from future liability.

RESA's statutory approach is just one that could be taken. In fact, even without new legislation, DOL already has flexibility to add similar language to the safe harbor through regulatory action. Whether by statute or regulation, the objective is to simplify the annuity selection process for fiduciaries by shifting the burden of information production to the most appropriate party—the insurance industry—and by providing employers with certainty they can rely upon standardized, comparative information about the financial strength of any given provider.

Proposal 2: Enhance the portability of annuity contracts in order to simplify plan operations

Challenge: Under ERISA, plan fiduciaries must monitor the appropriateness of the investment menu available to participants in their workplace retirement plans. As part of their review process, fiduciaries sometimes decide to change investment options offered to participants—or switch entirely from one investment firm to another. But if a fiduciary decides to eliminate an annuity option from the investment menu, the current regulatory framework does not provide clear standards for transferring accumulated income balances in a manner that enables plan participants to preserve the annuity's guarantee features.

Solution: A plan sponsor's decision to remove an annuity product from the menu of investment options should be treated as a "distributable event." Consequently, any participant invested in the product would be eligible to convert the annuity contract to an individual certificate or "roll over" the entire amount invested in the contract to an IRA that includes the insurer's equivalent (or near-equivalent) lifetime-income product. An approach along these lines is reflected in RESA.

By treating the in-plan discontinuation of an annuity product as a distributable event, participants would maintain significantly similar rights and benefits under their existing annuity contracts—while also preserving tax benefits available through a workplace plan. Additionally, such an enhancement to portability would ease administrative burdens on fiduciaries and reduce employers' reluctance to include annuity options in their investment menus.

Proposal 3: Broaden the QDIA regulations to further accommodate annuities, both as a component of an existing QDIA option and as QDIA themselves

Challenge: Employers rely on the relief from fiduciary liability available through the QDIA regulations when selecting default investment options for their plans. Such investment options also appeal to participants actively choosing their investments, who may view the QDIA designation as an endorsement. Today, QDIAs overwhelmingly dominate the allocations to the investment menu in most plans.

In legislation authorizing QDIAs, Congress directed the DOL to include investment options that offer either capital appreciation or capital preservation or both attributes as QDIAs. But DOL promulgated regulations that limit QDIAs to capital appreciation investment products. By definition, capital preservation is a hallmark of annuity-based investments. The exclusion of capital preservation products such as the traditional annuity with illiquid features has deterred employers from offering annuities in their investment menus, thus limiting participants' access.

A second challenge in the current regulations is that participants defaulted into a QDIA must have the ability to transfer out of it within any three-month period. This condition is not required by statute but has been adopted by the DOL under its rule-making authority. As a practical matter, it is difficult for insurance-based investment options to satisfy the 90-day transferability requirement.

In order to pay promised income to annuity purchasers, insurance companies must invest with a long-term investment horizon. Their investment portfolios also must satisfy state-law reserve requirements and permitted investment laws. As a result, many lifetime income options lack the liquidity and transferability of other types of investments such as mutual funds, which trade on a daily basis.

Further, many lifetime income options have built-in protection against market volatility and therefore should not have to provide frequent and immediate liquidity in order to protect plan investors against market downturns.

Solution: Solving the guarantee gap requires in-plan annuities, including those with illiquid features. The most efficient method for including these annuities in plan menus is by expanding the QDIA regulations. Enabling annuity-based products to qualify as QDIAs will provide employers with incentives—and critical relief from fiduciary liability—to include them in plan investment menus and therefore give participants greater access to guaranteed income in retirement.

By broadening the kinds of investments that can qualify, DOL can promote a second generation of QDIAs. This would be consistent with Congress' original intent to place an equivalent value on capital preservation and capital appreciation investments. DOL should take into account key differences in the investment and legal structure of annuities versus mutual-fund products. Finally, the 90-day transferability rule should be made more flexible so it aligns each QDIA with its inherent vulnerability to market volatility.

TIAA welcomes recent DOL support of initiatives intended to broaden the use of lifetime income products in workplace retirement plans. For example, DOL has recently confirmed that a TIAA “Income for Life Custom Portfolio”—which satisfies all requirements for a QDIA except that full transferability can only occur in an initial 12-month period—could be a default investment alternative that satisfies ERISA's fiduciary requirements.⁷² Additionally, TIAA applauds DOL's expressed interest in reviewing the QDIA regulations from a lifetime income perspective.



For Employees

Overcoming reluctance to invest in annuities

Proposal 4: Provide workplace retirement plan participants with an annual lifetime income disclosure statement

Challenge: Economists coined the term “annuity puzzle” to describe behavior they themselves find puzzling. Annuities are uniquely valuable products for making sure savings last throughout retirement, but relatively few Americans are comfortable buying them. One key piece of the puzzle is that annuities are absent from the primary place where most people learn about saving and investing—their retirement savings plan at work.

TIAA research indicates that many people are in fact interested in purchasing an investment offering guaranteed payments. As a recent study found, a majority of respondents would be willing to commit a portion of their workplace plan savings to an investment that would provide them a monthly payment, like an annuity. Yet, only about one-third are familiar with annuities.⁷³ That lack of familiarity causes many people to overlook or undervalue the benefits of annuities.

It is not only the absence of annuities but the dominance of mutual fund-type investments in workplace retirement plan menus that affects perceptions about annuities. Through their workplace plans, many plan participants learn some basic principles of investing, such as understanding rates of return and the relationship between risk and return. But because many plans do not offer annuities, participants receive no information about how to value an annuity as part of their investment portfolios.

An important body of research indicates that, if given information about annuities as if they were similar to an investment fund, people tend to prefer the investment fund. Yet, if instead people were given information describing the annuity's ability to produce a stream of income, many more prefer the annuity.⁷⁴ Under current law, however, plans are not required to give participants basic information about how to translate their savings into a stream of income.

Solution: To enable plan participants to better understand the benefits of lifetime income options such as annuities in a retirement portfolio, we advocate including lifetime income projections in an annual account statement. The statement would provide participants with an annual “checkup” on how their current investments would translate into income in retirement. In prior years, Congress supported such a requirement in RESA and other proposed legislation. Since 2007, bipartisan legislation, the Lifetime Income Disclosure Act, has been introduced into both the House and the Senate to give plan savers such annual statements.⁷⁵

And employers, too, seek this information. Wary of providing projections that some participants might view as guarantees, providers have asked for guidance from the DOL in the form of a model account statement to be provided to participants. In addition to ensuring that under ERISA all workplace retirement plan participants will annually receive a lifetime income illustration, these proposed laws would charge the DOL with issuing regulations describing relevant assumptions and authorizing language for use by employers in a model statement.⁷⁶ Finally, the proposals would provide employers and other fiduciaries using the model statement with critical relief from liability.

TIAA strongly supports providing lifetime income information to participants on at least an annual basis. Annual account statements should provide participants with information on how their current investments translate into lifetime income and how much of that income is *guaranteed*. TIAA has provided such information to its participants for over 50 years and now includes it in quarterly accounts statements.

Based on our experience, TIAA understands that employers prefer flexibility over rigidity in how they could be required to provide information to their participants. TIAA therefore also encourages Congress to authorize the DOL to provide employers with a reasonable range of permissible assumptions and methods to be used in preparing model statements.

Proposal 5: Give participants more access to flexible income distribution options

Challenge: *Pension policy analysts suggest that plan rules can play a major role in deterring participants from opting for guaranteed lifetime income as a distribution. Many require an “all-or-nothing” or “now-or-never” decision when deciding to opt for guaranteed lifetime income. Researchers believe that if “workers had an opportunity to ‘test drive’ an annuity for a limited period of time and become accustomed to its features, they would be more likely at the end to accept it permanently. The regular income stream (usually monthly payments), rather than the lump sum, might come to be seen as the status quo or presumptive form of benefit.”⁷⁷ But participants have no opportunity to decide for themselves how much of their savings should be used to purchase guaranteed retirement income. Nor do they have the flexibility to decide when it is best for them to do so.*

So, for many participants, it is easier not to make a decision and instead go with the status quo by choosing a lump sum distribution. The benefits of a lump sum distribution rolled over to an IRA are that they have the opportunity to decide later if, when and how much of their savings to annuitize. On the other hand, they lose the financial advantages of purchasing an in-plan annuity. Importantly, any annuity bought later will be purchased in the retail market, where fees and expenses are often significantly higher.

Solution: Giving participants more access to flexible income strategies (such as partial annuitization, trial annuities, systematic withdrawals, and required minimum distribution payments), could expose participants to the benefits of lifetime income without having to make an irrevocable decision with all of their assets.⁷⁸ Under this proposal, a plan could provide a lifetime income strategy in which participants would receive regular monthly payments from a combination of methods.

While integrating more flexible income strategies could help overcome participants' initial reluctance to choose a lifetime income distribution, it does raise some questions. From the industry perspective, what are the appropriate income strategy options? From a legal perspective, what changes to tax law and ERISA would be required to ensure that these income strategies benefit participants and provide relief from fiduciary liability for employers during the trial period? TIAA strongly urges the consideration of policies that will enable combination income strategies to become a commonplace feature in workplace retirement plans.

Proposal 6: Provide favorable tax treatment for guaranteed lifetime income in retirement

Challenge: *The taxation of investments is a complex subject but, in general, investments in equities are taxed at capital gains rates while guaranteed lifetime income products—like annuities—are taxed at ordinary income tax rates. Capital gains rates are often much lower than ordinary income tax rates. In essence, then, the tax code provides a disincentive for people to invest in annuities.*

Proponents argue that the preferential capital gains tax treatment is warranted because it encourages investment and increases productivity that results in economic growth. There are equally compelling arguments from both social and economic perspectives for providing a tax preference for annuity-generated income in retirement. For example, annuity income in retirement:

- *helps prevent poverty in old age and the associated drain on other social and economic resources;*
- *enables retirees to receive more “Social Security-like” income that reduces pressure on the Social Security program for benefit increases; and*
- *is guaranteed by financial institutions, unlike any other form of investment.*

Solution: TIAA supports providing guaranteed lifetime income in retirement a tax preference, which would give more incentives for employees to learn about and to invest in an in-plan annuity in their workplace retirement plans. A tax preference also would encourage more employees to consider an annuity form of payment when they take a retirement distribution.

Tax incentives for guaranteed lifetime income in retirement could take many forms. Some possibilities include:

- excluding all or a portion of guaranteed lifetime income from the income base used to calculate the tax on Social Security benefits (provided that the Social Security Trust Fund is protected against any related loss of income);
- excluding guaranteed lifetime income payments from income taxation if the recipients waive their rights to an equivalent amount of Social Security benefits; or
- taxing guaranteed lifetime income on the basis of either
 - a preferential tax rate similar to that available for long-term capital gains and qualified dividends, or
 - an exclusion (perhaps 50 percent) from income taxation for middle-income taxpayers.

TIAA encourages policymakers to consider tax policies that encourage and reward retirees for ensuring that they will not outlive their savings.

IV. Conclusion

The guarantee gap undermines the very purpose of the workplace retirement plan system, and meeting our nation's retirement policy challenges will require addressing that gap.

Past policy changes have driven this gap. Now, creative policy changes are needed to close it—by removing impediments to annuity adoption in workplace plans by employers and addressing employees' resistance to annuity investment.

TIAA is pleased to share our practical policy recommendations that could begin restoring the role of annuities in workplace retirement plans. We urge their serious consideration and stand ready to offer our expertise.



TIAA believes the key to solving the nation's retirement crisis is solving the guarantee gap.





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