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Before the Hearing on Certain Issues Relating to
Lifetime Income Options for Participants and Beneficiaries
In Retirement Plans

Employee Benefits Security Administration, U.S. Department of Labor, and
Internal Revenue Service, Department of the Treasury

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Thank you for the opportunity to address the U.S. Department of Labor and the Department of the Treasury on the question of retirement income options for plan participants and beneficiaries. Vanguard is one of the leading retirement services providers in the U.S. We provide administrative and investment services for both defined contribution and defined benefit plans. We are also known for our investment services provided to individual investors and financial advisers. As of June 30, 2010, Vanguard managed assets of $1.4 trillion on behalf of our clients—and we estimate that more than three-quarters of these assets are in some way directly or indirectly linked to the goal of retirement saving. At Vanguard, I lead our Center for Retirement Research. The Center is part of our Strategic Retirement Consulting organization, which is responsible for retirement policy, research and consulting activities at Vanguard.

Today, I would like to address three questions raised in the hearing notice: #1, participant concerns regarding lifetime income options; #2, the provision of information to participants regarding retirement income; and #5, alternative design considerations. We are pleased to offer these comments as a supplement to our response to the Departments' joint request for information (RFI) on retirement income.[1]

[1] See https://institutional.vanguard.com/iam/pdf/RIDWA.pdf.

1. Certain Specific Participant Concerns Affecting the Choice of Lifetime Income Options Relative to Other Options

The conventional view of retirement income decisions is that plan participants fail to take full advantage of income annuities. From this perspective, households face important investment and longevity risks in retirement, and optimally they should annuitize a meaningful portion of their retirement savings. Annuity income, in other words, should be viewed as a critical foundation of financial security in retirement. However, annuitization rates, both in qualified plans and in the financial system broadly, are quite low, suggesting that Americans are forfeiting valuable protection.

We view the issue differently. We recognize that participants already receive meaningful protection against market and longevity risk from Social Security benefits (and any traditional pension income). They have other "annuitized" wealth in the form of Medicare benefits and, for many, a primary residence.[2] These factors reduce the need for additional annuity income and enhance the desire for holding a portfolio of savings.

Given a minimum safety net of guaranteed income, many individuals are interested in retaining a portfolio of savings and spending down those assets flexibly over time. Liquidity (ready access to savings) and flexibility (in spending) are paramount. To many retirees, living on a fixed income is simply not the same thing as having financial security. A portfolio offers a household the ability to respond readily to the financial uncertainties that retirement may bring, including uncertain out-of-pocket health costs, long-term care costs, and later-in-life housing decisions. A portfolio of savings itself also provides a sense of financial security in retirement.

[2] Medicare benefits can be thought of as an annuity income that pays a material portion of health care costs conditional on incurring medical expenses; an owner-occupied house can be thought of as an annuity equal to the monthly rental expense a household avoids incurring by owning a home.

For these reasons, we anticipate that a portfolio withdrawal program, not an income annuity, will be the dominant income strategy used by retiring plan participants. Today at Vanguard, to assist investors with these needs, we currently offer a full suite of low-cost mutual funds suitable for constructing a retirement portfolio; we also offer systematic withdrawal services for qualified DC plans, IRAs and other investment accounts. Investors can set up a withdrawal plan (based on the 4% spending rule or a similar approach) either on their own or with the assistance from a Vanguard financial planner. They can also make use of our payout funds—a recent innovation in the marketplace where a mutual fund itself comes with a built-in payout stream. Regardless of the approach they choose, a portfolio of liquid savings, combined with a withdrawal feature, is likely to remain the dominant income-generating strategy for most participants.

Although we expect that withdrawal plans will be the dominant approach, there will still be some individuals seeking additional guaranteed income on top of Social Security and any traditional pension income. These investors may be highly risk-averse or very worried about market losses or income fluctuations. They may feel they lack the skill or interest needed in managing all of their retirement savings as a portfolio.

In today's marketplace, individuals seeking additional guaranteed income face a number of challenges. Information about competing annuities—including price comparisons, credit ratings and contract features—can be hard to obtain. Choosing among multiple providers can be time-consuming and difficult. For example, developing a list of annuity quotes from multiple insurers would involve engaging several salespersons at the same time, and undertaking a fairly daunting technical comparison of multiple contracts.

To improve the quality of decision-making surrounding annuities, we recently announced a new collaboration with Hueler Income Solutions to offer an online annuity marketplace for Vanguard IRA investors.[3] The program, Vanguard Annuity Access powered by Income Solutions, combines the online marketplace created by Hueler Companies with service and support from Vanguard's annuity specialists. Our new annuity program emphasizes comparability, transparency, choice, and low cost—the same principles underlying Vanguard's investment offerings.[4]

With Vanguard Annuity Access powered by Income Solutions, Vanguard IRA investors can compare annuity quotes from leading insurance companies, all on an "apples to apples" basis, and all at low, transparent commission rates. Potential investors can also turn to our annuity experts to answer their detailed questions, whether about annuities in general or about specific pricing, product or contract features.

It's important to note that our new annuity program is offered "outside the qualified plan." From a plan sponsor perspective, a within-plan option has raised concerns about fiduciary oversight of insurers and increased complexity of plan administration. Sponsors also remain concerned about portability of in-plan options, both for the plan and participants, as well as low in-plan demand from participants.

We believe Vanguard Annuity Access will address some of the market structure concerns that may impede annuity adoption. The program will reduce the hurdles investors face in obtaining information about annuities and in making informed, apples-to-apples comparisons among competing bids. It allows potential purchasers to evaluate the pricing of annuities over time, conveniently from their computer desktop. The

[3] The program is also available for investors with nonqualified (taxable) assets.
[4] For details, please see: https://personal.vanguard.com/us/whatweoffer/annuities/income.

prospective investor is in control of how much in savings to annuitize (there are no “all-or-nothing” annuity choices), and can even choose to diversify credit risk by purchasing annuities from more than one insurer.

While we believe that Vanguard Annuity Access is a valuable “beyond the plan” option that participants have at retirement, we do not expect that it will fundamentally alter the decision-making dynamic for many individuals. Most participants will want to remain invested throughout retirement, and will want to generate a significant part of their income using a withdrawal plan—a plan they establish on their own, with the help of a financial planner or adviser, or with the new generation of payout funds. As we’ve noted above, this preference for a portfolio-based withdrawal plan reflects rational preferences for liquidity and flexibility, given the presence of a safety net from Social Security and other programs and assets. However, for those participants who are seeking additional guaranteed income, a program like Vanguard Annuity Access powered by Income Solutions offers a convenient, low-cost way to evaluate annuities. We anticipate that the new program will enhance the quality of information in the marketplace and improve decision-making by self-directed annuity purchasers.

2. Information to Help Participants Make Choices Regarding Management and Spend Down of Retirement Benefits

The information needed by participants in the spend-down phase closely parallels that needed during the accumulation phase. We would include the following information within the scope of retirement income education:

- *Income planning.* Descriptions of sources and types of retirement income, along with worksheets, calculators and other tools that help participants estimate their retirement income needs and available sources. Typical sources include Social Security, traditional pensions, withdrawals from retirement accounts, earnings from part-time or other work, and so forth, along with spouse/partner resources.
- *Drawdown risks.* Descriptions of the risks that participants will face in the spend-down phase, such as investment, inflation, health care cost and longevity risks.
- *Asset allocation.* Asset allocation strategies for retirement savings appropriate for the drawdown rather than the accumulation phase (e.g., a shift to a more conservative portfolio approach, the role of different asset classes in the spend-down phase, the idea of a larger cash reserve for spending needs).
- *Income-generating strategies/ products.* Descriptions of the types of financial instruments available to create an income stream from a pool of savings. These include: (1) nonguaranteed or portfolio-based strategies that emphasize liquidity of assets and flexibility of spending, such as income investing, systematic withdrawal plans (including the 4% spending rule), and payout funds; and (2) annuity-based strategies that provide some form of guaranteed income, typically for life, such as traditional immediate income annuities, deferred annuities, variable annuities with guaranteed income riders, and longevity insurance.

- *Benefit, risk and cost comparisons.* Comparisons of the merits of different income-generating strategies, including benefits, risks and costs.
- *Retirement income worksheets and other tools.* Worksheets, calculators or other tools to help participants determine how to allocate their aggregate savings, both plan-related and non-plan savings, among a range of retirement income choices.
- *Case studies.* Case studies of participants illustrating the types of retirement income choices they made given their circumstances. In the same way that Interpretive Bulletin 96-1 today permits sample portfolios for accumulation investors, revised guidance could encourage sample case studies and "retirement income plans" for hypothetical investors. For example, Participant A has chosen to annuitize half his savings and draw down from the other half; Participant B has chosen to draw down from half of her portfolio and invest the other half for long-term needs in the later years of retirement.
- *Other forms of retirement income.* Discussion of other retirement income programs not directly related to qualified plan savings (e.g., reverse mortgages, the role of part-time work, generating income from taxable savings).
- *Taxation issues.* Tax-related information with respect to retirement income options, such as tax efficient drawdown strategies, the impact of required minimum distribution rules after age 70½, tax rules governing various income sources (e.g., Social Security taxation, IRA versus taxable account versus annuity taxation rules), tax effects upon death of the account holder (taxes payable by beneficiaries, the estate tax).

This is an extensive list of topics. We would expect that, just as with accumulation phase education today, plan sponsors and service providers would exercise judgment in determining the breath and depth of the information included in various participant materials. For many participants, basic materials will be sufficient. More advanced concepts, or strategies that may only be applicable to small groups of participants, can be offered in a more targeted way.

Also, it worth emphasizing that plan communications and participant education are increasingly being provided in electronic form. E-communication strategies include public websites, company intranets, e-meetings and web videos. Communications experts are weighing how to use portable devices (such as smartphones or iPads) and social media for financial education. Programs also continue to be provided in print and in other traditional media, such as face-to-face group meetings or workshops. We anticipate that drawdown education, like accumulation education, will make active use of both electronic and non-electronic media.

An important consideration in revised guidance is to clearly authorize plan education about income options that exist "outside the plan." Over 80% of retiring Vanguard DC plan participants exit their employer's qualified plan within three years of retirement. Most roll over their assets to an IRA. In order for participants to make informed choices about the ultimate disposition of their qualified plan savings, it is critical that participants understand not only the income options that exist within their employer plan, but also the choices they face upon plan distribution. For example, revised guidance could clarify the difference between endorsing beyond-the-plan options, which would give rise to fiduciary oversight, versus simply describing the availability or existence of such options, which would not.

3. Alternative Designs of In-Plan and Distribution Lifetime Income Options

We would like to comment on two issues: the question of whether retirement income options will be "in plan" or "out of plan," and the way that default arrangements might be used to encourage retirement income.

In plan versus out of plan. We anticipate that most retirement income decisions will occur in the IRA marketplace. As noted earlier, sponsors remain concerned about taking on added fiduciary responsibility for retirement income products, as well as increasing the complexity of plan administration. For annuity-based products, of concern to some sponsors is the fiduciary problem of overseeing legacy annuity providers that plan fiduciaries no longer consider a prudent selection.[5] For portfolio-based solutions, such as payout funds, most are relatively new and sponsors are reluctant to add them to plans until their features are better understood. The one income option that sponsors can easily add in a qualified plan is to allow retired participants to establish systematic withdrawal plans from their accounts. Such a feature does not entail adding new plan investment options or increasing fiduciary responsibility.

On the participant side, we anticipate in-plan demand for retirement income options to be low. As noted above, over 80% of retiring participants in Vanguard DC-administered plans leave the plan within three years, typically for an IRA rollover

[5] For example, suppose a sponsor authorizes Company A's deferred annuity as an investment option for the plan. Over time, the sponsor's fiduciary view of Company A changes, and it introduces a new deferred annuity option from Company B. Unfortunately, it cannot remove participant monies from Company A's product, even though its fiduciary view has changed, without a loss of the guarantee provided to those participants. Thus, the plan must retain both products, even though the sponsor no longer approves of Company A as an appropriate option.

account.[6] We surmise that this behavior is the result of three factors: (1) a participant's desire to consolidate and have direct control over his or her savings at the household level, independent of rules imposed by an employer plan; (2) the inevitable weakening of the bond between an employer and a retired employee; and (3) the active role played by advisers in encouraging participants to have their assets managed outside the plan. At the same time, there are countervailing forces that will encourage more participants to retain some assets in their employer's plan. Certain asset classes, such as stable value investments, are only available in qualified plans; many larger plans also offer institutionally-priced options, which are typically offered at significantly lower cost than available in most IRAs.

Role of defaults. One proposed strategy for encouraging greater annuitization is the idea of default partial or trial annuitization.[7] In this arrangement, part of a participant's account is payable only as a 24-month income stream. At the end of the 24 months, the money is transferred to an annuity on an opt-out basis. In other words, if participants take no action at the end of the period, that portion of their account balance converts automatically to an irrevocable annuity income stream.

As we noted in our written RFI response, we believe default annuity arrangements will have a modest or even negligible effect on annuitization, given the preference among

[6] The result is similar whether the plan allows in-retirement distributions or not. Many DC plans impose an "all or nothing" approach to in-retirement distributions. In these plans, participants may not take partial withdrawals once they have separated from service. In order to access any part of their savings, they must take a lump sum distribution of their entire account balance. Some plans also impose a "70½ and out" rule; they require a full lump sum distribution by age 70½ in order to administering avoid required minimum distribution rules, which impose a significant penalty (plan disqualification) in the event of errors.

[7] See William G. Gale, Mark J. Iwry, David C. John and Lina Walker, 2008, "Increasing Annuitization in 401(k) Plans with Automatic Trial Income." The Retirement Security Project, No. 2008-2, Washington, DC. http://www.brookings.edu/~/media/Files/rc/papers/2008/06_annuities_gale/06_annuities_gale.pdf.

most participants to retain a portfolio of savings in retirement. The desire for liquidity and flexibility is quite strong.

Moreover, there is no clear analogy between the use of automatic enrollment in the accumulation phase and default trial annuitization. Automatic enrollment's largest effects are on a subset of the participant population (low wage and younger participants who typically do not join a 401(k) plan). These participants are likely to have low levels of financial sophistication and engagement in retirement planning. The financial impact of automatic enrollment is relatively modest and can be easily ended: the participant is only making small contributions from ongoing pay, and can stop at any time. By comparison, participants subject to a default annuity rule will encompass the entire population of retiring DC plan participants, many of whom are accustomed to making their own decisions. Because these participants will be dealing with a substantial accumulation of resources, their level of attentiveness and their engagement will be high. And given the use of an annuity as the default instrument, the financial impact of not taking action will be very costly: if participants do not take action, they will permanently lose access to a meaningful portion of their savings.[8] Finally, tax effects will also be permanent and irreversible (in other words, the annuity income stream will be a permanent stream of possibly taxable income). For all of these reasons, we envision that participants will work actively to opt-out of default annuity arrangements.

Absent any strong preference by participants for annuitization, we believe that an appropriate default arrangement is one that generates some reasonable income, while preserving liquidity and flexibility for the participant. Thus, a more desirable default

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[8] In our research on DB lump sum versus annuity payouts, we found that retirees were more likely to be active decision-makers and opt-out of an annuity default. See Gary R. Mottola and Stephen P. Utkus. "Lump Sum or Annuity? An Analysis of Choice in DB Pension Payouts." Vanguard Center for Retirement Research, November 2007. https://institutional.vanguard.com/ iip /pdf/CRRLSA.pdf.

approach would be a withdrawal amount set at 3% or 4% of assets. Given this baseline of income, participants can then decide whether to make a more consequential and irreversible financial decision, namely whether to annuitize a portion of savings. Even though we think this withdrawal approach is a more desirable default, we would not actually recommend that it be designated as a true opt-out default, given the fact that any plan withdrawal has potential tax consequences for the participant. Rather, we could imagine a situation where the plan creates a standard feature, called the 3% or 4% withdrawal feature, in which the rate, the calculation method, and the creation of a monthly series of payments is set up automatically. Participants can then choose whether to sign up for this standard withdrawal feature—or not.

Given the complex nature of retirement income choices, the irreversible nature of annuitization, and potential tax liabilities, we anticipate that most participants prefer to make active decisions at retirement. They will want to be involved in weighing the benefits, risks and costs of alternative strategies. Today, the choice set for participants outside the plan is complex: withdrawal plans from a portfolio; payout funds and other non-guaranteed income from mutual funds or other portfolios; and a wide range of traditional and nontraditional annuity contracts. Our belief is that participants must be presented with a full array of approaches, as well as with supporting education, advice and service, that will allow them to make an informed, active decision. In the current marketplace, the role of a default arrangement will likely be unduly restrictive.