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Lifetime Income Solutions as a Qualified Default Investment Alternative (QDIA)  
Focus on Decumulation and Rollover

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Thank you for the opportunity to address the committee on this important topic. Prior to joining the American College, I served as Director of the Retirement Planning and Living Consortium at Texas Tech University and I continue to conduct research in efficient retirement income strategies.

Since its inception in 2006, the QDIA concept has become a remarkably powerful retirement policy tool in the United States. In 2005, defined contribution plan participants held \$48 billion in target date and life cycle mutual fund assets, and \$16 billion was held in IRAs<sup>1</sup>. By 2017, DC participants held \$749 billion in these QDIA-friendly mutual funds and \$222 billion is now invested in IRAs.

The increase from \$48 billion to \$749 billion in defined contribution assets invested in target date mutual funds over ten years didn't happen because the product was better, cheaper, or because they were added to participant menus. Prior to establishing the QDIA, target date funds were available in 57% of plans, which rose to just 65% of plans by 2015. Fewer than one in five participants owned target date funds before the QDIA, however, and now half own them. Total wealth held in target date funds rose from 5% to now 20% of total defined contribution assets and will continue to rise in the future.

The theoretical efficiency of the life cycle mutual fund structure was well known among economists long before the QDIA<sup>2</sup>. Despite being an optimal choice for most workers, few invested in life cycle funds before being defaulted into them. There is a similar consensus among academic economists that workers should annuitize at least part of their savings at retirement, and that the failure to buy annuities is a puzzle.

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<sup>1</sup> 2018 Investment Company Institute Fact Book, [https://www.ici.org/pdf/2018\\_factbook.pdf](https://www.ici.org/pdf/2018_factbook.pdf)

<sup>2</sup> Bodie, Zvi, Merton, Robert C. and William F. Samuelson. 1992. Labor Supply Flexibility and Portfolio Choice in the Life Cycle Model, " Journal of Economic Dynamics and Control, 16(3-4), 427-449.

Most target date funds place the majority of a worker's savings in short-duration bond investments at retirement age. The failure to annuitize results in significantly lower and riskier incomes for retirees who must spread their bond savings over an unknown lifespan. Even lower-income retirees who may not live as long as higher-income plan participants are still significantly better off annuitizing<sup>3</sup>. So few Americans today buy annuities that most economists who conduct research in this area focus on understanding the so-called annuity puzzle rather than estimating whether annuities are the right investment choice for retirees<sup>4</sup>.

Converting bonds to income annuities as part of a QDIA glidepath is the easiest way to solve the annuity puzzle. My comments today will focus on more practical matters of how best to design a QDIA that incorporates guaranteed income. Making modest changes to the existing QDIA guidelines will improve portfolio allocation consistency and create greater retirement security through partial annuitization.

### **A New Glidepath**

The traditional life cycle fund follows an asset allocation glidepath that reduces portfolio risk as a worker nears retirement. Retirement savings are then turned into spending in retirement. Volatile investments ideally fund more flexible spending goals like leisure spending, and safe assets fund less flexible spending categories like health care and property taxes. A simple way to increase the level of safe spending in retirement is to convert bond assets into annuities. This can be accomplished by investing a portfolio of the bond allocation within a QDIA glidepath to annuities, which has been referred to as an annuity sleeve.

There are a number of options available to create this so-called annuity sleeve. Although arbitrary, a simple strategy, and one that is perhaps the easiest to implement, is to begin converting the bond portion of a QDIA portfolio to annuities when a worker's glidepath stock allocation falls to some fixed portfolio allocation, say 60%. At this point in the age glidepath, the QDIA will maintain this 60% equity allocation in the investment component of a QDIA while subsequently converting an increasing share of new contributions to the annuity sleeve. Building a sleeve gradually has important behavioral benefits since workers' overall retirement savings continue to rise even after contributions to the sleeve begin.

I see no harm in prescribing an age at which this transition occurs, for example age 50, and relaxing liquidity requirements for the annuity sleeve. I also see no harm standardizing the glidepath allocation in retirement to, for example, 60% equities at age 50, when the annuity sleeve begins, and total bond allocation of 70%, including the annuity sleeve, by age 65. Being more prescriptive about glidepath percentages at specific ages will fix what I see as a significant potential problem with the existing QDIA structure, which is the variation in portfolio risk among QDIA funds.

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<sup>3</sup> Michael, Olivia, Brown, Jeffrey R., Poterba, James M., and Mark J. Warshawsky. 1999. "New Evidence on the Money's Worth of Individual Annuities," *The American Economic Review*, 89(5), 1299-1318.

<sup>4</sup> Richard Thaler, 2011, *The Annuity Puzzle*,  
<https://www.nytimes.com/2011/06/05/business/economy/05view.html>

Should all QDIAs incorporate an annuity sleeve? In my opinion, we should begin by explicitly shielding plan sponsors from risks associated with adopting annuities into QDIAs, and then move toward adopting a mandatory partial annuitization glidepath in QDIAs.

The committee should also consider the benefits and potential costs of creating the annuity sleeve. I believe that the benefits outweigh the costs. The average worker will benefit from knowing how much base guaranteed income they will have in retirement before they retire, participants can receive some mortality credits prior to annuitizing, and their bond assets used to purchase annuities can be placed in a longer-duration bond portfolio that may outperform traditional QDIA bond assets. The cost is potentially higher expenses and a possible loss of liquidity. It is imperative that there are incentives to reduce costs of the annuity sleeve in the same way that litigation risk to plan sponsors has reduced the average expense ratios of QDIA investments.

### **The Problem with Provider Selection**

The amazing success of the QDIA, which has moved millions of Americans from a highly suboptimal, overly conservative default investment portfolio inappropriate for their life cycle stage, provides a powerful reminder that plan sponsors are strongly motivated to avoid getting sued. A decade removed from the original QDIA, it's worth reviewing what is working well with current regulation of the plan design features.

Creating a structure for investment defaults that minimized liability risk arguably reduced variation and innovation in default investments to a framework that was theoretically closer to optimal for most workers. Target date funds assume homogeneous investor risk preferences independent of age. They assume a homogeneous decrease in the percentage of wealth held in human capital, which is the basis for the slope of the stock allocation investment glidepath. These assumptions mean that these default funds are ideal for no single worker but likely far more ideal than a no-risk default investment. Deviating too far from this protected fund structure results in increased liability risk, which causes plan sponsors to select funds that hew closely to QDIA parameters.

The benefit of product homogeneity is the ease in which plan sponsors, and those who sue them, can make quality comparisons. This has served to drive the average participant investment management costs in QDIAs down sharply. In any consumer market where product homogeneity is preserved through regulation, commoditization results in increased price competition and lower costs for consumers. Commoditization trades the benefits of product heterogeneity for lower prices. This tradeoff seems to have worked remarkably well for workers who aren't sophisticated consumers of investment products. According to Morningstar data, dollar-weighted returns of target date fund investors exceed the performance of other mutual fund categories.

Annuities are different. Price competition for promised future income may not be as beneficial for consumers if the plan sponsor bears the burden of liability for defaulting employees into a less than ideal annuity. Why? Let's consider the likely impact of creating a simple guaranteed income annuity QDIA structure. Plan sponsors will need to select an annuity provider that

promises the best deal to participants within this structure. Should the plan sponsor select the provider who promises the highest income per dollar invested? Should they select the provider that does not make income promises so generous that they are less likely to fulfill future income obligations? Do employers possess the investigative and actuarial skills needed to evaluate the likelihood that an annuity provider will be able to fulfill their future income obligations to a large group of employees? Expense ratios are much easier to evaluate than the financial stability of an insurance company.

ERISA exists because firms promising future income to employees have short-run incentives that conflict with the long-run well being of workers. There is no reason to believe that this conflict in incentives will be eliminated by simply allowing firms to provide annuities within QDIAs with only the oversight of today's insurance regulatory structure, plan sponsors and general product structure rules. I also do not believe that plan sponsors are the most effective monitors of annuity product quality.

Simple solutions such as standardized reserve requirements and consistent oversight are the first step, but the committee needs to look closely at whether these requirements are enough. The unique regulation of insurance companies could result in some incentive for regulatory arbitrage among states, especially if the annuity market expands rapidly by incorporating guaranteed income into QDIAs. Who bears the liability risk of a significant change in longevity among workers? There must be some safeguard in place to ensure that guaranteed income in the annuity sleeve is not subject to random changes in either asset returns or changes in worker lifespans.

## **Conclusion**

The unwillingness to offer annuities is particularly alarming since the post-QDIA generations of workers are increasingly defaulted into set-it-and-forget-it retirement investments. At retirement, these same participants are not offered a sensible set-it-and-forget-it way to turn these savings into spending. Failing to consider how QDIAs are turned into income at retirement is a significant problem that can only be solved by giving plan sponsors a strong incentive to incorporate guaranteed income.

Although guaranteed income in QDIAs will improve retiree well-being by providing greater spending clarity and insuring against the risk of outliving retirement savings, the annuity product is far more complex than a mutual fund. A specific income guarantee involves predicting when workers will die in the future, and what bond returns will be. Higher-earning participants live longer, and providing them with lifetime income is more expensive. The promise of future income among a large pool of participants creates incentives for insufficiently regulated providers to offer benefits that they may not be able to pay in the future.

The purpose of the QDIA is to provide a structure that will result in greater retirement security for the average worker. Defaults were an important step to getting more Americans to save in better retirement investments. Despite the complexity of QDIA annuities, I have no doubt that incorporating guaranteed income into the QDIA is needed to more effectively transition defined contributions into defined spending in retirement.