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U.S. Department of Labor Advisory Council on Employee Welfare and Pension Benefit Plans
Dr. Michael Finke Testimony on Qualified Default Investment Alternatives

Dear members of the ERISA Advisory Council,

An income annuity allows retirees to spend as if they expect to live to an average longevity. Because none of us know how long we will live, the alternative is to spend cautiously to avoid running out. Plan participants will spend more at retirement if a portion of their savings are turned into an annuity.

In order to create an income annuity, you need a portfolio of assets and a group of retirees. The amount of money each retiree can spend depends on the estimate of how long the retirees will live. Estimating how much income can be fairly withdrawn from the portfolio each year is what makes an annuity different from traditional investments.

Consider the advantages of pooling investments together to create a stream of lifetime income. First, the retiree knows how much they can safely spend. If I know that I can spend $1,000 per month for life, I have a better understanding of what my retirement lifestyle will be than if I had $150,000 in a bond ladder. Second, I will spend more. At today's interest rates, a retiree who wants her savings to last to age 95 will spend only $750 per month. When the money runs out at 95, the average woman who saves in a defined contribution plan will still have about a one in four chance of being alive. Bond mutual funds common in target-date funds are subject to interest rate risk and even less efficient at producing stable income than a bond ladder.

Third, Americans with annuitized income spend even more than economic theory would predict[1]. Retirees appear to be less willing to spend from savings than from income. This means that many retirees spend down their defined contribution savings according to RMD rules, which results in a highly volatile spending path that eventually depletes in old age. Finally, annuities provide a form of dementia insurance. After age 85, roughly 30% of Americans are experiencing measurable cognitive decline that would make managing investments difficult[2]. Turning savings into a lifetime income stream in old age ensures lifestyle preservation protected from financial mistakes and abuse.

Annuities are perfect for defaults. Participants who remain in the investment default tend to be less financially sophisticated[3]. If placed into a default annuity, they are less likely to make an active change and more likely to view the annuity default as an endorsement. The 68% percent of

1 https://www.protectedincome.org/license-to-spend/
2 https://jamanetwork.com/journals/jama/fullarticle/2761651
3 https://www.sciencedirect.com/science/article/abs/pii/S0167268119302744

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workers who currently invest in target-date funds benefit from delegating portfolio management to an expert, and should benefit from the same expert guidance in decumulation.

An additional benefit of adding annuities to default investments is that the mortality pool of default participants is more favorable than the pool of retail annuity buyers. In my research, I find that the average DC participant has an expected longevity after the age of 65 that is about 2 years less than a retail annuity buyer. Expected longevity among default participants is about a half year shorter than a self-directed participant[4]. Even with unisex pricing, men would receive a higher actuarially fair income from an annuity offered within a DC plan, and women would receive an even larger boost in income. The costs of distribution would likely also be lower than retail annuities.

Compared to withdrawing income from a stock and bond portfolio, we estimate a welfare improvement of 19% for a risk-averse woman who annuitizes 25% of her $500,000 of retirement savings and a welfare increase of 35% if she annuitizes half of her savings. This likely underestimates the improvement in well-being from partial annuitization since retirees spend more than theory would predict from lifetime income, and retirees often perform worse than younger investors when managing their investments.

While the need for more annuities in DC plans is obvious, there is more that can be done to increase adoption of annuity products by plan sponsors. I will address three main barriers – insolvency risk, product design, and liquidity.

For private annuities to work, the pooled assets used to generate income need to be managed prudently to ensure that there will be funds available to pay for income liabilities in the distant future. States provide oversight over insurer solvency through risk-based capital rules, ratings agencies provide estimates of solvency risk, and there are state guaranty funds that provide insolvency protection, generally up to $250,000. Regulatory arbitrage is limited to some extent by the collective imposition of capital requirements adopted by National Association of Insurance Commissioners.

The firm-specific risk from owning an annuity isn't comparable to owning a long duration bond from a single company since the insurer is required to hold a minimum amount of high-quality assets to meet future liabilities. There has, however, been increasing scrutiny of the methods some insurers use to increase portfolio risk to earn higher expected returns from general account assets. The framework for limiting excessive portfolio risk may allow some room for creativity.

[4] https://www.protectedincome.org/wp-content/uploads/2022/08/RP-12_Blanchett-Finke_v3.pdf

Historically, credit ratings of insurance companies have been a good predictor of subsequent liquidation, and cumulative 10-year liquidation rates are below 2% for A-rated insurers[5]. Even when an insurer is liquidated, this may or may not impact the regular income received by annuity owners if liabilities are absorbed by another insurer. Although historical failures have rarely impacted annuity owners, adding annuities to DC plans and in particular to defaults would substantially increase income liabilities within the industry and potentially stress state guarantee funds. Despite the growth of annuity sales in recent years, the percentage of annuities that provide lifetime income through annuitization or lifetime income guarantees remains a fraction of annuities in the marketplace.

Even when a plan sponsor or investment manager selects a highly rated insurer, they have little control over the risk of that liability once the annuity is purchased. A highly rated insurer can be acquired by a lower-rated company, the insurer may itself experience a credit downgrade, or the insurer may sell a block of annuity liabilities to a lower-rated insurer to profit off the risk-arbitrage yield spread. The offloading of annuity liabilities to lower-rate insurers has occurred in pension risk transfers resulting in an implied wealth loss to workers.

It is sensible to anticipate misaligned incentives between annuity owners who value a stable lifetime income and insurers who owe loyalty to shareholders. A novel solution would be to immediately offer commutation to annuity owners when the annuity liability is sold to a lower-rated insurer, when the company's rating is downgraded by a specified amount, or when the company is acquired by a lower-rated insurer. Commutation should be large enough to represent the current fair market value of the annuity liability. Of course, annuity owners would need to be notified of the change in income risk and be given a window of time to initiate the payment. This would reduce the benefits of risk arbitrage and create a healthier market for liability transfers.

Credit risk only exists because insurers control investment assets and make income promises based on mortality predictions. Neither of these are necessary to provide annuity owners the benefit of pooling assets to transfer longevity risk. Contemporary tontine annuities allow some income flexibility based on performance of pooled assets and mortality experience of retirees. In other words, the risk that assets won't perform as well as expected, or that retirees will live significantly longer than predicted, is borne by the annuity owner, resulting in less income certainty but also less risk that the insurer will be unable to pay for annuity liabilities.

An example of a contemporary tontine design would be a cohort-based asset pool (say 65-year old retirees) that is invested in bonds that match the expected duration of future annuity cash flows. These assets could or could not be comingled with the general account portfolio of the insurer and a transparent asset management fee could be applied to compensate the insurer for

5 https://publications.investmentsandwealth.org/iwmonitor/vol__22__no__1__2023/MobilePagedArticle.action?articleId=1931588#articleId1931588

managing the pool. Payouts would be made based on an actuarily fair payout rate with modest annual income adjustments applied to reflect mortality experience of the pool. Numerous flexible annuity designs exist today in the retail market, for example participating annuities among mutual insurers in the United States and dynamic pension pools in Canada, but few exist within DC outside the CREF annuity offered by TIAA.

Investment products can be designed to provide most of the pooling benefits and income certainty of an annuity. Such a design may invest a portion in a traditional ladder of bonds whose maturity matches income payments from retirement through a specified age, for example age 80. Income after age 80 would be derived from either a longevity annuity or some other pooled asset design such as a closed-end fund that can transfer longevity risk to the group of retirees. Since the increased spending provided through mortality risk pooling, also known as mortality credits, occurs primarily after age 80, this type of design can provide much of the welfare benefit of a traditional annuity with greater expense transparency and reduced insolvency risk.

There are uncertainties around the legality of tontine-like pooled investment structures that offer longevity risk protection. This is an area where clarity is desperately needed to facilitate product innovation. Tontines offer investment management pricing clarity, transparency of asset holdings, longevity risk protection, and can be designed to provide participants with a degree of liquidity. Tontines do not provide the same guaranteed income stability as annuitization through an insurer and there is no appropriate framework for regulatory oversight.

A common retail annuity product design that provides longevity risk protection and access to liquidity is a fixed or variable annuity with a guaranteed lifetime withdrawal benefit, or GLWB. The GLWB gives annuitants the option to withdraw a specific amount from assets within the annuity each month in a manner similar to an irrevocable immediate annuity. The cost of lifetime income protection is typically levied through a GLWB fee, which should be seen as an insurance premium since the amount collected will be used to pay for claims of retirees who outlive their savings. Most GLWBs are offered on fixed annuities that are constructed entirely or primarily with bonds, and income guarantees will be higher for fixed than variable annuities.

A GLWB offers numerous advantages over an irrevocable annuity. The value of investments within the annuity can be accessed and, unlike a participating annuity or tontine, the GLWB provides a guaranteed stable lifetime income.

GLWBs can also be blended more easily with an investment portfolio than annuitization. A fixed lifetime income annuity uses bonds to create a stable income. The remaining investment assets should ideally be rebalanced to reflect the transfer of bonds from an investment portfolio to a lifetime income guarantee constructed with bonds, but the shadow nature of the annuity value means that the rest of the portfolio will have a higher stock allocation. For example, a retiree with $500,000 saved in a 60% bond, 40% stock target-date fund might annuitize $200,000 of the bond portion of their portfolio, leaving them with a 67% stock allocation. This is an appropriate

asset reallocation that reduces overall spending risk, but can be difficult to implement in practice. Since a fixed GLWB is constructed primarily using bonds, it is easily integrated into the bond portfolio without the challenges of a shadow asset.

Lifetime income benefits generally must be initiated by participants. Since all GLWB owners pay the insurance premium, if only a fraction use the income benefit there will be a cross-subsidy from those who do not withdraw the income to those who take advantage of the lifetime benefit. This has led to GLWB rates that rival and sometimes even exceed SPIA rates in the retail market. Others may withdraw too much from the annuity, impairing their ability to benefit from the GLWB.

GLWB annuities are prone to suboptimal use by less sophisticated retirees. A simple solution is to require that GLWB annuities offered within a default automatically begin making GLWB payments at retirement. A participant can elect to stop receiving payments, but the average default participant will benefit from inertia. A downside of this requirement is that the payout rates will be lower than they are in the retail market where rates are buoyed by the cross subsidy. Since GLWBs retain a liquidity option and will suffer from some moral hazard liquidation risk (for example by those who are diagnosed with a disease), they should have lower payout rates than irrevocable annuities.

While GLWBs offer the benefit of liquidity, workers will receive a higher income if their annuitized assets are less liquid. A current proposal to offer participants 180 days to withdraw default assets used to purchase an annuity provides the benefit of flexibility and then allows the insurer to invest the annuity premium in a portfolio of long-term bond assets to meet guaranteed future income payments through the annuity. An insurer would experience a substantial loss if interest rates rose and participants were offered full liquidity. Of course, pensions offer the same future income certainty without liquidty and few who are eligible to receive a pension are unhappy with the tradeoff. The benefit of less liquidity is the ability to receive a future income guarantee that gives workers a clearer idea of how much they can spend when they retire.

It is also important to point out that annuity products designed for a defined contribution plan will look different than products offered in the retail market. Retail products are tailored to solve specific individual financial planning needs and appeal to different segments of consumers. An ERISA in-plan annuity is selected by a fiduciary to meet the needs of a plan. Sales of retail annuities are almost entirely incentivized through commissions, which means that retail annuities are sold. In-plan annuity offerings outside of a default aren't likely to gain much traction despite their theoretical value, similar to target-date funds before the Pension Protection Act. In-plan annuities can meet the income needs of an average participant and are most likely to be adopted in defaults.

A recent LIMRA survey of plan sponsors finds that 49% are currently considering in-plan annuity options[6]. Before they do, product manufacturers need to be given every opportunity to design creative products that give participants the peace of mind of lifetime income and freedom from fear of uncertainty. There may also be a role for a PBGC-like entity that could oversee the market for income products provided through DC plans to address barriers to product innovation and manage insolvency risk.

The average retirement savings balance of 65-74 year old household is $426,000[7]. Allocating 40% of these savings, or about 2/3 of a QDIA bond allocation at retirement age, to an income annuity would give the average retiree an extra $1,000 of lifetime spending each month with more than $250,000 remaining to fund flexible lifestyle expenses. Retirees would live better and spend more with less anxiety using QDIAs that turned a portion of their savings into a secure lifetime income.

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6 https://www.limra.com/en/newsroom/industry-trends/2023/are-in-plan-annuities-at-a-tipping-point/
7 https://www.federalreserve.gov/publications/files/scf23.pdf

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