

**Written Testimony of J. Mark Iwry
On Behalf of The Retirement Security Project**

**Before the Working Group on Spend Down of Defined
Contribution Assets at Retirement**

**U.S. Department of Labor Advisory Council on
Employee Welfare and Pension Benefit Plans**

September 10, 2008

Chairwoman Dill, Vice Chairman Koepfel, and members of the Working Group, thank you for the opportunity, on behalf of the Retirement Security Project¹, to present our views on the “spend down of defined contribution assets at retirement.”

I am a Principal of the Retirement Security Project as well as a Nonresident Senior Fellow at the Brookings Institution, Research Professor at Georgetown University, and formerly the Benefits Tax Counsel, in charge of national private pension and benefits policy and regulation, at the U.S. Department of the Treasury. (A summary of my background is attached.) The other two Principals of the Retirement Security Project are William Gale, Director (also Director of Economic Studies at the Brookings Institution) and David John (also a Senior Research Fellow at The Heritage Foundation).

The Retirement Security Project is a nonpartisan, nonprofit organization supported by The Pew Charitable Trusts in partnership with Georgetown University’s Public Policy Institute and the Brookings Institution. The Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers. Our goal is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

¹ The views expressed in this testimony are my own and those of the Retirement Security Project, but should not be attributed to the Brookings Institution, Georgetown University’s Public Policy Institute, the Pew Charitable Trusts, the Heritage Foundation, the Rockefeller Foundation, the Hamilton Project, or any other organization, including any other organization with which I or the Retirement Security Project are affiliated. This testimony and the attached paper are a part of the Retirement Security Project’s ongoing project on promoting retirement security through lifetime retirement income, which is funded by the Rockefeller Foundation.

Automatic Trial Income Proposal

Our testimony today summarizes a recent Retirement Security Project paper titled "Increasing Annuitization in 401(k) Plans with Automatic Trial Income" (attached) by William G. Gale, myself, David C. John and Lina Walker.² The Gale-Iwry-John-Walker Automatic Trial Income paper proposes a policy that would increase the role of lifetime and other retirement income products in future retirees' overall retirement planning.³

Over the next few decades, a substantial number of workers will retire with larger balances in their retirement accounts and have fewer sources of longevity protection than retirees today. They, therefore, must manage these resources to ensure they last throughout their retirement – a difficult task that results in many running out of assets too soon while others hoard their savings to a greater extent than necessary. Lifetime income products would benefit many because payments are made for life and thus mitigate the risk of running out of resources late in life, and because they tend to permit a higher monthly payment (while protecting against the risk of exhausting one's savings) than nonannuity options.

Despite the benefits of lifetime income, however, current retirees do not use lifetime income products very much, and future retirees seem unlikely to do so under current arrangements. One reason may be that retirees feel they already have sufficient guarantees -- for example, from social security benefits -- against the risk of outliving their resources. However, evidence suggests that various other factors are at play as well; among other things, the retail market for lifetime income products appears not to function well, and many people do not understand annuities and harbor behavioral biases against them.

Our paper explores a strategy that would seek to address these factors by making it easier for a substantial number of retirees to purchase lifetime income. The resulting increased volume of sales and wider pool of annuitants could be expected to reduce prices and make annuity products a better value for the average consumer. The strategy also addresses the role of ignorance and bias by giving retirees an opportunity to "test drive" a lifetime income product. This would be designed to help overcome existing biases, reframe retirees' view of lifetime income, and improve their ability to evaluate their retirement distribution options.

Specifically, we propose that a substantial portion of each participant's account balance in 401(k) and other similar plans be automatically directed (defaulted) into a

² Lina Walker, PhD., is Research Director of the Retirement Security Project. An earlier version of the attached Gale-Iwry-John-Walker paper was published by the Hamilton Project as Discussion Paper 2008-2 (June 2008).

³ The material in this section of this testimony, including this paragraph and the next six paragraphs, is taken verbatim or nearly verbatim from the attached Gale-Iwry-John-Walker Automatic Trial Income paper (both the abstract and the body of the paper), but quotation marks have been omitted.

two-year trial income product when retirees take distributions, unless they affirmatively choose not to participate. The automatic trial income arrangement would make 24 consecutive monthly payments to an individual on a voluntary basis, i.e., if the individual did not opt out. At the end of the trial period, retirees could elect an alternative distribution option, but if they did nothing, they then would be defaulted into a permanent income payment program. Employers and plan sponsors would be encouraged to offer the trial income plan and would have discretion over some of its structure and implementation.

An automatic “trial” period of monthly income based on a substantial portion of their assets could accustom individuals to the consistency, security, and simplicity of receiving regular monthly payments and help reframe the way they view their retirement resources. The regular income stream (or “pension paycheck”), rather than the lump sum, may come to be seen as the status quo or presumptive form of benefit.

A variety of important questions would have to be resolved before this strategy could be implemented. The attached Gale-Iwry-John-Walker paper seeks to map out the first of several steps toward increasing the use of income products in 401(k)-type plans, with the ultimate goal of facilitating improved retirement outcomes for workers.

Other Possible Approaches

The automatic trial income paper also contains a number of other specific proposals or potential initiatives designed to promote wider consideration and use of regular periodic retirement income. One such initiative, designed to take into account the impact on typical human behavior of the way an issue or choice is defined or “framed”, would require defined contribution plans and IRAs to reframe their account statements. “To help reinforce a sense of ownership of the income stream rather than of only the lump sum, DC plan sponsors and IRA providers should be required to present the participant’s benefits as a stream of monthly or annual lifetime payments in regular statements and in summary plan descriptions, in addition to presenting the benefits as an account balance in accordance with current practice.”⁴

The witness is in the process of developing two additional papers in collaboration with co-author John Turner under the auspices of the Retirement Security Project. For these papers, we are currently considering a number of other possible initiatives, and are planning to explore both their advantages and their drawbacks.

⁴ Gale-Iwry-John-Walker paper at 20. “It may be possible to develop an industry-wide method of computing and presenting the stream of payments, with appropriate disclaimers.” Ibid. In a sense, the trial income proposed above and the gradual acquisition of annuity income units in the accumulation phase, described below, take framing the next step -- from presentation of a hypothetical or potential form of benefit to action (actual payment or accumulation of benefits in the form of regular income).

Summarized very briefly here, these other possible initiatives may include the following:

A behavioral strategy for encouraging lifetime income by gradually introducing it as a default investment during the 401(k) accumulation phase, including, specifically, embedding it in the target maturity QDIA

Target maturity or life cycle default investments are increasingly prevalent in 401(k) plans after the Pension Protection Act of 2006 and the Department of Labor's "QDIA" regulations. Thus far, these funds generally have been well accepted by employees as a means of achieving asset allocation and diversification that reflects a consensus among much of the expert financial advisory community. Typically the target maturity fund increases the percentage of assets dedicated to fixed income investments over an employee's career.

The steadily growing fixed income component of the life cycle fund might be comprised of annuity income units that accumulate gradually over time. If plan sponsors chose to offer such funds, they would spread the risk of interest rate fluctuations at the point of purchase – a kind of "dollar cost averaging" – while enlisting inertia in the cause of persuading 401(k) participants to allow a portion of their account balance to be invested in deferred annuities. (This would not be the traditional deferred annuity that is often used only as an investment vehicle and not actually paid out in regular installments over the owner's lifetime, but instead would be designed mainly to provide lifetime guaranteed income beginning after retirement.)

Because annuity income units would accumulate gradually, participants would have no single "moment of truth" at which the decision whether to take an annuity would be thrust upon them with the urgency of a deadline and with the high stakes associated with a decision on the disposition of one's entire retirement nest egg. Instead, at any given moment, only a fraction of current plan contributions would be invested automatically (by default) in the annuity income units (potentially as part of the life cycle fund). Participants would have the usual ability to opt out of the default life cycle investment fund, and plans of course could offer, as other investment options, life cycle funds that use fixed income investments instead of annuity income units.

A behavioral strategy for encouraging lifetime income by gradually introducing it via employer matching (and nonmatching) contributions

As noted, a key element in a strategy for encouraging lifetime income may be to avoid the traditional all-or-nothing annuitization choice that confronted many plan participants in the past. For many, purchase of lifetime or other periodic income might not make sense for their entire account balance, but only for a portion (if any), and the portion might vary from one individual or household to the next depending on their circumstances. In typical 401(k) plans, a portion of the

incoming contributions could be directed to the accumulation of deferred annuity units by providing – if the employer chose to do so -- that the employer matching contribution will be so invested. The employer could make such an investment mandatory or could make it the default, allowing participants to opt for a different investment.

There are several potential advantages of using employer contributions in this way.

First, many plan sponsors in the past have made their employer contributions in the form of employer stock or have provided that they were to be invested in employer stock, subject, perhaps, to participants' ability to elect otherwise. Now that Congress has limited employers' ability to force investment of matching contributions in employer stock, there is an opportunity to use a similarly assertive approach with respect to the investment of employer contributions in the interest of enhancing employees' retirement security. As a broad generalization, 401(k) participants on average would be better served by less employer stock and more lifetime income.

Second, participants who are skeptical about turning their assets over to an insurance carrier may be more accepting of "employer money" being invested in annuity income. While economic analysis suggests that, in the long run, most employer contributions and benefits can be expected to come out of the overall employee compensation package, and thus most of the cost might ultimately be borne by employees, framing matters. Employees and employers perceive a distinction between employee and employer contributions, and employees may feel that their employer is entitled to decide how "its own contributions" are used. This should be even more true in the case of employer nonelective or nonmatching contributions.

Third, this use of employer matching contributions can occur gradually during the accumulation phase, thus "framing" participant expectations to anticipate that the "employer matching" portion of their account balance will be used to provide lifetime income. The gradual approach also mitigates the interest rate risk by acquiring units over time.

Fourth, this use of employer contributions avoids presenting the employee with an "all or nothing" choice. Employer matching contributions often account for about a third of the account balance (or slightly less). To many employees, this might feel like about the right amount of their account balance to devote to lifetime income.

Both the QDIA and the employer matching strategies could be structured to complement the trial income strategy summarized earlier.

Longevity Insurance in Qualified Plans

In addition, among other measures, we believe a good case can be made for longevity insurance in employer plans, as some have proposed. Deferring the start of an annuity until an advanced age such as 85 helps counteract the “wealth illusion” that keeps some employees from converting any of their account balance to periodic income. Being unaccustomed to converting present values to payment streams and vice versa, many employees are unpleasantly surprised to learn how “small” the monthly payments would be relative to their “large” account balance if they chose to use the account balance to purchase lifetime income. This “sticker shock” can be countered to some degree by showing employees that they could purchase a meaningful amount of late-in-life longevity insurance in exchange for only a portion of their account balance. (The larger benefits have time to accumulate and are funded in part by the premiums paid by those who die earlier.) The employee could retain the rest of the account balance to provide the financial flexibility to meet economic “shocks” such as unexpected medical or long-term care needs (or for bequests).

In addition, this long-deferred annuity helps make the “spend down” problem more manageable. Individuals no longer need to manage their assets over an uncertain time period. Instead, they can target their efforts to making the assets last until a date certain when the annuity would take effect. The longevity insurance protects mostly against the “tail” of the life span probability distribution – the lower-probability risk that the participant will live to a very advanced age.⁵

* * * * *

Each of these strategies – automatic trial income; automatically embedding lifetime income in the QDIA; automatically acquiring lifetime income with employer contributions; and offering longevity insurance – takes a step in the direction of replicating, within the 401(k), one of the valued attributes of the traditional defined benefit pension – guaranteed lifetime income at group rates (combined, in most cases, with professional investment management).

Thank you for the opportunity to share our views with you. I would be glad to answer any questions.

⁵ As others have noted, facilitating the use of longevity insurance would involve accommodating it within the minimum required distribution rules under the Internal Revenue Code.

J. Mark Iwry

Mark Iwry (pronounced “Eevry”) is a Nonresident Senior Fellow at the Brookings Institution, a Principal of the Retirement Security Project, Research Professor at Georgetown University, and Of Counsel to the law firm of Sullivan & Cromwell LLP, where he specializes in pensions, compensation and benefits. He was Benefits Tax Counsel at the U.S. Treasury Department from 1995 to 2001, serving as the principal Executive Branch official directly responsible for tax policy and regulation relating to the Nation’s qualified pension and 401(k) plans, employer-sponsored health plans, and other employee benefits.

Recently named one of the 100 Most Influential People in Finance (*Treasury and Risk Magazine*, June 2008), Mr. Iwry has often testified before congressional committees – formerly representing the Treasury and Executive Branch and, since leaving government, testifying as an independent expert -- and State legislatures. He has advised numerous Senators and Members of Congress on both sides of the aisle, five Presidential campaigns (2004 and 2008), GAO, other federal agencies, State officials and legislators, foreign government agencies and officials (including the United Kingdom and Israel), AARP, and other private-sector organizations on retirement savings, and has served as an expert witness in federal litigation. He was formerly a partner in the law firm of Covington & Burling, chair of the D.C. Bar Employee Benefits Committee, a member of the White House Task Force on Health Care Reform, and has addressed several hundred professional, industry, policy and academic conferences. Mr. Iwry co-edited the book, “Aging Gracefully: Ideas to Improve Retirement Security in America” (Century Fdn. Press, 2006)(with William Gale and Peter Orszag); the automatic IRA proposal he has co-authored through the Retirement Security Project has been introduced as a bill in Congress, and the proposals he has co-authored to leverage State resources to expand pension coverage have been introduced as bills in several States.

A principal architect of the Saver’s Credit to expand 401(k) and IRA coverage (claimed annually on 5.3 million tax returns) and the “SIMPLE” 401(k)-type plan (covering an estimated 3 million workers), Mr. Iwry directed Treasury’s formulation and implementation of an integrated strategy to increase retirement saving by defining, approving and promoting 401(k) automatic enrollment as well as automatic rollover to curtail pension leakage. He has also been centrally involved in initiating or orchestrating many other significant improvements and simplifications of the nation’s pension and health care systems, including development of the Presidential “Universal Savings Accounts” proposal (1999-2000), and strengthening oversight of the PBGC by its Board of Directors.

While in government, Mr. Iwry was widely recognized for his work to expand coverage while simplifying and rationalizing benefits law and regulation. He received the Secretary of the Treasury’s Exceptional Service Award “[i]n recognition of his outstanding leadership and accomplishmentsWidely respected as Treasury’s benefits and pension expert, Mr. Iwry excelled at building coalitions of diverse interests....” At Treasury, he drew upon a wide spectrum of private sector advice, held town hall meetings around the country, and received a special IRS (Office of Chief Counsel) award “[i]n recognition of the collegial working relationship you have fostered between [Treasury] and the IRS Office of Chief Counsel and of your many contributions to our nation’s tax system.”

Mr. Iwry’s views are often reported in the major media and trade press. He is an honors graduate of Harvard College and Harvard Law School, has a Masters in Public Policy from Harvard’s Kennedy School of Government, is a member of the bar of the US Supreme Court, a Fellow of the American College of Employee Benefits Counsel, and is listed in *Who’s Who*; *Best Lawyers in America*; *Washington, DC Super Lawyers*, etc.

Email: miwry@brookings.edu