# Pension Plan Fix-It Handbook

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# DOL Shares Vision for Benefit Illustrations Of Lifetime Income Streams

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The U.S. Department of Labor, after reviewing more than 700 responses to a request for information issued with IRS in February 2010 on lifetime income options in retirement plans, believes the perception of retirement savings needs to change. Rather than seeing the funds as a savings account, the agency wants participants to view them as a source of retirement income.

DOL issued an advance notice of proposed rulemaking on May 8 regarding the inclusion of lifetime income illustrations in defined contribution plan benefit statements. (To read it, go to: http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=26806.) In conjunction with the issuance of the ANPRM, DOL has made a lifetime income calculator available on its website at: http://www.dol.gov/ebsa/regs/lifetimeincomecalculator.html. (See box on p. 3.)

The notice provides much more detail, invites comments (due July 8) and welcomes sample benefit statements or similar documents currently providing illustrations of lifetime income payments.

Before we delve into the ANPRM, a look at its footnotes provides a some interesting statistics, including:

- The number of private defined benefit plans decreased more than 50 percent, to less than 48,000 in 2009 from 103,000 in 1975, while the number of defined contribution plans increased over 200 percent in the same period.[1]
- Recent studies indicate that providing participants with lifetime income illustrations that show their retirement savings would not meet their retirement income needs would encourage participants to start saving more.[2]
- Workers' wages increase faster at younger ages and tend to mirror inflation later in life.[3]
- Inflation has averaged 3.2 percent since 1913 (according to consumer price index data from the Bureau of Labor Statistics) and will average 2.8 percent between 2019 and 2086 (assumption by trustees of the Social Security Trust Fund, who predict how long the trust will last.)
- Just 18 percent of private-industry workers in 2010 participated in a DC plan with an annuity option.[4]

Based on these findings, as well as responses to the 2010 RFI, DOL says it believes that showing participants how much their current and projected account balance will provide monthly in retirement will be helpful to workers. With this as a backdrop, let's discuss the ANPRM.

[1]Employee Benefits Security Administration, U.S. Department of Labor, *Private Pension Plan Bulletin Historical Tables and Graphs* (March 2012), Table E1: Number of Pension Plans by type of Plan, 1975–2009, at *http://www.dol.gov/ebsa/pdf/historicaltables.pdf.*

[2]See Goda, Gopi Shah; Colleen Flaherty Manchester; and Aaron Sojourner, "What Will My Account Really Be Worth? An Experiment on Exponential Growth Bias and Retirement Saving," NBER Working Paper 17927, March 2012. See also *ACLI Retirement Choices Study,* Greenwald & Associates, April 2010.

[3]See, for example, Murphy, Kevin M. and Finis Welch, "Empirical Age-Earnings Profiles," *Journal of Labor Economics,* Vol. 8, No. 2 (April 1990), pp. 202–229.

[4]See Table 21a of DOL, Bureau of Labor Statistics, "National Compensation Survey: Health and Retirement Plan Provisions in Private Industry in the United States, 2010," Bulletin 2770, August 2011. Available at: *http://www.bls.gov/ncs/ebs/ detailedprovisions/2010/ownership/private/ table21a.pdf.*

**See *Lifetime Income*, p. 2**

## *Lifetime Income* (continued from p. 1)

### Background

ERISA Section 105(a) requires that DC plan participants receive a periodic (at least annual) benefit statement providing the participant's total accrued benefit. This statement must be provided quarterly, if the plan is self-directed. DOL now is considering requiring that the accrued benefit be presented as a lifetime income stream of monthly payments. In addition, both DOL and IRS are considering issuing a regulation or some other means of facilitating payment of account balances, for employer-sponsored retirement plans and individual retirement accounts, in an ongoing stream of income after retirement.

### Overview of Intended Regulations

DOL is considering requiring a benefit statement to include an illustration converting the participant's account balance to an estimated lifetime stream of payments with these criteria in mind:

- assuming the participant and/or beneficiary had reached normal retirement age as of the date of the benefit statement;
- for participants who haven't reached NRA, the account balance is projected to NRA based on assumptions regarding future contributions and investment returns. The projected account balance would be converted to a lifetime stream of payments;
- the lifetime stream of payments would be presented as monthly payments based on one's expected mortality based on mortality tables; and
- the lifetime stream of income would be presented based on the joint lives of the participant and spouse, if married.

Key issues being reviewed include:

- showing a lifetime stream of monthly payments based on current account balance, projected account balance or both;
- methodology for projecting an account balance;
- methodology for converting an account balance into a lifetime stream of monthly payments;
- assumptions about future contributions and investment returns, among other influences; and
- use of incremental annuities.

### *Current vs. Projected Account Balance*

Interestingly, the RFI respondents were split on which account balance to use. Those supporting using current balances said they believed that it would be better to base the illustration on the account balance that the participant actually has, rather than what the participant may have at some point in the future. Projected account balances are based on assumptions (for example, future contributions and investment returns) that represent, at most, a best guess. Using current account balances may motivate the participant to save more if the monthly payments appear small, supporters argue.

Those in favor of using projected account balances said they felt this way because projections are commonly used in financial planning and therefore a projected account balance would be more meaningful to the participant. Comments noted that not all assumptions about future account balances are flawed and asked that DOL provide reasonable parameters about assumptions to prevent abuse or misleading results. Lifetime income streams based on current account balances have no relevance to people years from retirement and could discourage savings. In addition, because account balances constantly change, illustrations based on current account balances may vary dramatically.

Comments supporting both points of view noted the importance of providing understandable illustrations.

DOL said both points of view are valid. It is considering a proposal that would provide participants with a current account balance and a projected account balance with lifetime income illustrations based on both balances, unless the participant was at NRA, when only the current balance would be used.

### *Methodology for Projecting an Account Balance*

The ANPRM goes into detail regarding assumptions and projections, but the overarching goal is that the projections:

- be meaningful to participants and beneficiaries;
- not be overly burdensome for administrators; and
- avoid new regulatory guidance affecting current best practices for projections and illustrations or hampering potential innovation.

DOL is requesting comments on five variables it says are critical to projecting an account balance:

1) current account balance;

2) number of years until retirement;

3) future contributions;

4) rate of investment return; and

5) inflation adjustment.

See *Lifetime Income,* p. 3

## *Lifetime Income* **(continued from p. 2)**

The agency also is interested in learning if there any other variables that should be factored into the projection.

DOL is considering a general rule as well as a safe harbor. The general rule does not require any one method or specific assumptions; rather it would require "reasonable assumptions taking into account generally accepted investment theories." The safe harbor would require specific assumptions that would be considered reasonable, if used by the plan. They include:

- contributions continuing to NRA;
- increasing contributions based on a 3-percent annual wage increase;
- 7-percent investment return; and
- a 3-percent discount rate.

DOL is interested in comments on the use of the plan's NRA vs. some other date, such as Social Security retirement date, when projecting the participant's current account balance.

### *Methodology for Converting Account Balances into a Stream of Monthly Payments*

DOL would use the annuitization approach, which would present the picture of monthly payments similarly to what would be presented for ongoing distributions from a DB plan. The agency is considering five relevant factors in converting the account balance:

1) the annuity start date;
2) age of the participant and/or beneficiary;
3) form of payment;
4) expected age of mortality; and
5) mortality period's interest rate.

### *Disclosures and Other Items*

DOL also is interested in receiving comments on the types of disclosures that would help participants and beneficiaries understand the consequences of purchasing an annuity. Another area of consideration is the use of "incremental" or "accumulating" annuities. Such arrangements would allow participants to make ongoing contributions toward the purchase of a future stream of payments, resulting in multiple annuity purchases. The ANPRM provides more information on this, as well as an example.

### *Plan Sponsor Considerations*

The ANPRM provides an opportunity for plan sponsors to comment on offering an annuity form of payment, which could become a requirement for DC plans they administer.

The next step in the regulatory process is likely to be public hearings, followed by proposed regulations and then final ones. Plan sponsors should comment now to have a chance to influence future guidance.

Some things for you to think about:

- Will the inclusion of lifetime-stream-of-income illustrations lead your participants to think that an annuity option is already available? A disclaimer could eliminate that concern but could raise questions about why the plan doesn't already have an annuity option.

**See *Lifetime Income*, p. 4**

## How the Proposed Calculator Works

The U.S. Department of Labor on May 8 included a proposed online lifetime income calculator with its advance notice of proposed rulemaking on pension benefit statements showing retirement account balances as an estimated lifetime income stream. Using assumptions described in the ANPRM, the calculator shows an annuitization approach to estimate the monthly lifetime income streams based on both the participant's current account balance and on the projected value of that balance at retirement, according to the agency's website. A participant enters his or her proposed retirement age, current retirement savings balance, current annual contribution, years until retirement and the statement date associated with the balance information to get:

- the estimated monthly lifetime income payment he or she would receive today from the current account balance provided; and
- a projected account balance looking ahead to the present value of what the participant will have saved by the retirement age entered.

For both balances, the calculator develops two level lifetime payments: one for the life of the participant (with no benefits to any survivors) and the second for the joint lives of the participant and the spouse with a 50-percent survivor's benefit for the spouse's lifetime. The calculator uses a simplified computation (employing, for example, annual contributions and midyear retirement). Depending on the comments received, the next version of the calculator may provide a more precise computation that would include monthly contribution amounts, DOL said.

To use the proposed income stream calculator, go to: http://www.dol.gov/ebsa/regs/lifetimeincomecalculator.html.

## *Lifetime Income* (continued from p. 3)

- The ANPRM offers guidelines for various assumptions but many employee populations may not lend themselves to a one-size-fits-all approach. Your conservative employees might find counting on a 7-percent investment return too risky, for example.
- Annuity amounts depend on a number of factors, including the participant's gender. The proposed assumptions do not take this into account, which results in an illustration that is understated for males and overstated for females.
- Advising participants to use the DOL lifetime income calculator might be a viable approach for all; if you think that is the case, tell DOL.