

Lifetime Income Illustrations Come of Age

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Political Objectives. A key retirement security goal of the Obama administration is to reduce the risk that retirees will outlive or lose their savings and to promote the conversion of 401(k) plan assets into guaranteed lifetime income products. To this end, the DOL, IRS, and Treasury Department issued a joint release in February 2010 requesting information regarding lifetime income options for participants in retirement plans. The request addressed a range of topics including participant education, tax-qualification rules, selection of annuity providers, ERISA Section 404(c), and QDIA relief from fiduciary liability and required disclosure of the lifetime equivalent of account balances.

In September 2010, the same agencies held a two-day joint hearing to consider issues raised in the various comments submitted by the public in response to the agencies' request. The hearing addressed a number of issues, but focused on three specific areas of interest: (1) fostering education to help participants make informed retirement income decisions; (2) modifying the existing fiduciary safe harbor for selecting annuity products and issuers; and (3) disclosure of account balances as monthly income streams along the lines of the various legislative proposals. The DOL further narrowed its focus and took a first step toward actual change in a May 7, 2013 advance notice of proposed rulemaking that would require lifetime income illustrations to be included in pension benefit statements. The goal of this proposal is to give participants an understanding of how much projected retirement income they can expect from their savings. This may, in turn, affect decisions as to the level of future savings, investment allocations, and the timing of distributions.

Basic Disclosures. Section 105 of ERISA requires the administrator of

an individual account plan to furnish its participants with quarterly benefit statements if the plan permits them to direct investments, and annual statements if it does not. Any benefit statement furnished must indicate the total benefits accrued on the basis of the latest available information.

Under this authority, the DOL proposal would require benefit statements to include:

- A participant's current account balance as of the last day of the period covered by the statement;
- The account balance projected to normal retirement age, expressed in current dollars (*i.e.*, the projected amount's present value), taking into account future contributions and investment returns;
- The lifetime income stream derived from the current account balance; and
- Another lifetime income stream based on the projected account balance.

For this purpose, lifetime income is to be expressed as a level monthly amount payable for life commencing on the day after the quarterly or annual period being reported as if the participant had attained normal retirement age on that date. Statements furnished to married participants must show these payments as if made under a joint and 50 percent survivor annuity, for which purpose it may be assumed that the spouse is the same age as the participant. The DOL believes that this information will enable participants to make more informed retirement planning decisions and may encourage greater savings.

Methodology and Assumptions. The critical parts of the benefit statement proposal are the methodology and assumptions used to project account balances and convert them into lifetime payments.

Projections. With respect to projections, the proposal allows plan administrators to select the method and assumptions to be used based on a standard of reasonableness. The intent of this general rule is to permit a broad array of best practices and allow for innovation. Certainty can be attained, however, by following the prescriptions of a safe harbor that relies on three specific assumptions: (1) Contributions will continue to normal retirement age at their current annual dollar amount (not the contribution percentage) increased by three percent per year; (2) investment returns of seven percent per year; and (3) a discount rate of three percent (reflecting historic inflation) to bring the calculation back to current dollars.

The DOL has not made a final decision on any of these assumptions, and after explaining its reasoning for choosing them, requests comments from the public on whether a revision of the assumptions would be in order. For example, the DOL worries that the three percent annual increase in contributions may not be sufficiently conservative and that harm could be done by overestimating such increases. Similarly, the DOL is concerned about the effects on participant behavior of the 7 percent investment return assumption and asks for comment on whether a more conservative assumption might be warranted.

Conversions. As to the methodology for converting an account balance into lifetime payments, the DOL proposal rules out systematic withdrawals whereby a fixed amount or percentage is distributed annually, because of the possibility that the account will eventually be used up. The proposal opts for a payment methodology involving annuitization based on interest rate and mortality factors that results in monthly payments for life.

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The proposal provides that the interest rate and mortality assumptions on which a lifetime income stream is based must be reasonable, taking into account generally accepted actuarial principles. As in the case of the rules for projecting accounts, this general rule is intended to maintain flexibility and preserve existing best practices. It is worrisome to some, however, because of the potential liability under ERISA that may go along with picking the assumptions. Therefore, a safe harbor interest rate is provided equal to the rate of 10-year constant maturity Treasury securities for the first business day of the last month of the period to which a benefit statement relates. The proposal also contains a safe harbor mortality assumption that utilizes the applicable unisex mortality table under Section 417(e)(3)(B) of the Internal Revenue Code in effect for the month that contains the last day of the statement period. These safe harbor assumptions.

The proposed disclosure rules require communication to participants

of any assumptions used in the benefit statement with regard to the projected account balance and the illustration of lifetime income streams. A benefit statement must also include an explanation that the lifetime stream is only an illustration or estimate and that actual periodic payments that may be purchased at retirement may vary substantially from the illustration. The DOL believes that this will go a long way toward making it clear that projected amounts are not guarantees. With respect to the possibility of participant lawsuits based on unfulfilled expectations created by benefit statements, the DOL also thinks that a plan administrator could minimize the possibility of liability for imprudent or improper calculations by using the safe harbor factors.

Cost Considerations. Most of those who have responded to the DOL's request for information favor lifetime income illustrations. However, many responders objected to the cost of mandatory disclosure. The DOL maintains that the proposed additional disclosures will not significantly increase the cost of benefit

statements; notwithstanding, it has requested comments on the costs and benefits of the new illustrations. It has also specifically asked for comments as to whether there would be substantial savings if illustrations were required only annually rather than quarterly.

Another approach to achieving cost savings that is being explored is the DOL's publication of a table of conversion factors based on the safe harbor assumptions.

A further cost savings possibility on which comment is being requested is requiring all benefit statements to include illustrations that assume that participants are married.

Moving Forward. The comment period for the benefit statement proposal ends July 8, 2013. The proposal remains quite tentative in a number of respects, and the DOL is ostensibly open to alternative means of achieving its goals. ❖

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