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Annuity Illustrated

DOL's Lifetime Income Disclosure Rules Are (Mostly) Reasonable; Will Participants Notice?

By the end of next year, some 77 million 401(k) and other defined contribution (DC) plan participant benefit statements will include a new chart showing how much monthly income they might get if they bought an annuity with their account balance and happened to be 67 years old. Participants also will learn how much they and their hypothetical spouses with the same birthday would receive if they bought a joint and survivor annuity. Backing up the chart will be a Department of Labor (DOL)-written "understandable explanation."

The genesis of the new chart is the 2019 Setting Every Community Up for Retirement Enhancement (SECURE) Act of amendment of the Employee Retirement Income Security Act (ERISA) disclosure rules requiring that all DC participants benefit statements include, at least annually, an estimate of how much retirement income they could reasonably expect from their current plan balance. Like most legislation, Congress left the DOL with the heavy lifting of how to run the numbers and effectively communicate the results to participants. On August 18, the DOL issued Interim Final Rules laying out the rules and asking for feedback, within 60 days, for possible improvements. The goal is to get folks to save more and, at retirement, consider buying an annuity with at least a portion of their nest egg. The reality is likely to be somewhat different.

To translate a cash lump sum into a lifetime of payments, you'd at least need to know how old the person will be when payments start, when they'll die, and what discount rate to use. You also need to decide if and how to factor in the effects of future inflation and, if the person was not ready to retire, by how much the lump sum would grow until retirement and the workings of real world insured annuity markets. Let's look at what's baked into the DOL's estimates, the frightful required explanation, and how much it is likely to move the retirement needle.

WHEN PAYMENTS BEGIN

The estimate assumes monthly payments begin at age 67, the full Social Security retirement age for anyone born in 1960 or later. The only exception is for someone already over 67, when his or her current age will be used. Although most employees retire by age 65 or earlier, 67 is as good an age as any and may nudge some to consider working a bit longer. In its preamble, the DOL asked for comments on adding other ages like 62 (Social Security early retirement) or 70 (Social Security late retirement). Given that recordkeepers will automate calculations of these estimates, I expect them to add drop-down menus on their e-statements allowing folks to choose various ages.

WHEN YOU'LL DIE

The DOL requires that mortality be measured using the Internal Revenue Code Section 417(e)(3)(B) unisex tables. These tables are regularly updated by the Internal Revenue Service and easily accessible. The DOL is using a unisex table, thus avoiding gender issues and problems of bad or missing sex data. The required participant explanation will mention the real-world fact that women live longer than men do and their annuity payments will pay a bit lower (and vice versa).

DISCOUNT RATE

For this crucial assumption—which most participants, financially literate or not, will ignore—the DOL chose the 10-year constant maturity Treasury (CMT) securities yield rate on the first business day of the last month of the period to which the benefit statement relates (*e.g.,* December 1, 2021, for year-end 2021). Again, this figure is easily accessed and updated monthly. The DOL noted that while this benchmark is a bit lower than some others, it approximates real world annuity costs. Remember, the lower the discount rate, the lower the monthly payments. Also, rather than factoring in "loads"—insurance company expenses & profit—the DOL chose a conservative rate, in part to make the estimates more reflective of actual annuity costs. In fact, based on my admittedly unscientific study, the discount rate is so conservative that participants actually could expect higher monthly payments than the DOL's estimates (*see* Reality Check, below).

FORM OF PAYMENT

Both a single life annuity and joint and 100-percent survivor annuity beginning at age 67 are to be shown. For practical reasons, the beneficiary for the survivor annuity is assumed to be the same age, 67, as the participant. Strangely, even if the participant is single, the beneficiary is assumed to be a spouse, and there is no indication in the estimate or explanation that a non-spouse also can be the survivor beneficiary. This will create confusion; the commercial annuity market doesn't care whether the survivor is a spouse, domestic partner, sibling, or the UPS driver.

IMPORTANT BUT IGNORED

The estimates ignore a lot of important stuff in the name of simplicity and administrative ease. For example, while a worker's account will likely appreciate from investment income faster than inflation, a 30- and 50-year-old with an identical account balance will see the same age 67 monthly payment on his or her statement. Clearly, the 30-year-old is in better financial shape. Baking in future real investment return involves too many variables for a simple, one-size-fits-all illustration. Yet, the DOL explanation should, but does not, discuss investment return. On the other hand, the explanation does, correctly, discuss the negative effects of inflation on the value of the fixed monthly payment. Also ignored are the myriad of annuity options that might be available in the annuity market. Perfect being the enemy of good, the DOL rightly keeps the illustration reasonably simple.

REALITY CHECK

I asked a knowledgeable and generous actuary to run numbers using the DOL's rules assuming a $100,000 account balance on July 30, 2020. He came up with a single life and joint and 100-percent survivor payments of $450.54 and $365.61 per month. Using the DOL model, this participant's illustration would look like this:

Account Balance as of 7/30/2020	Monthly Payment at 67 (Single-Life Annuity)	Monthly Payment at 67 (Qualified Joint and 100% Survivor Annuity)
$100,000	$450.54/month for life of participant.	$365.61/month for life of participant. $365.61/month for life of participant's surviving spouse.

I then asked an insurance broker and used a popular Web site to see how much a 67-year-old male and female New Yorker (costs vary by state) could expect per month in the annuity market with $100,000 to spend. Surprisingly, the quotes from financially solid insurance companies and relatively low-fee products showed monthly payments that were 7- to 10-percent higher than the DOL illustrations. In financial planning, it's better to be a bit conservative and get a positive surprise at retirement than get hit with bad news when it may be too late to act. Then again, if my back of the envelope reality test is accurate, the DOL methodology may be overly cautious. Further work is needed.

UNDERSTANDABLE EXPLANATION

The biggest problem with the new rules is that the government's participant explanation of how to read and use the estimate is more likely to baffle than inform. And, because using the DOL's wording is the only way for employers and recordkeepers to avoid getting sued, everybody will use it. (More on that below.) One problem is that, at two pages, the explanation is too long. Getting folks to read one paragraph is difficult, with one page the limit of human patience. Not only will most people not get to page two but the length will also discourage many from even reading the first paragraph. Second, the explanation was written by lawyers, and it shows. Lawyers are trained to think of all possible outcomes—especially what can go wrong. But such fulsome explanations don't get read, and unread disclosure is worthless. Also, lawyers tend toward jargon, defined terms, and pet phrases that either bore or scare readers and stymie comprehension.

Here's an idea. Lock the lawyers in a closet and hire an English lit major for a complete rewrite. Or, better yet, hire one or two of the many theater critics or restaurant reviewers with nothing much to write about to draft the explanation. (I bet you could get a sports writer really cheap.) The lawyers can review but should only be allowed to make an edit if their heads would otherwise explode.

LITIGATION PROTECTION

Employers, recordkeepers, and the like are naturally concerned about litigation by participants claiming that they did or did not do something because of "misleading" estimates and disclosure. Thus, ERISA and the new rules offer protection if the calculations are performed using the required assumptions and the DOL model language is used. Although employers and recordkeepers may craft their own explanations, they do so at their own risk, losing the ERISA liability protection unless their description is "substantially similar" in all "material respects" to the government's. The DOL's examples of immaterial changes is ridiculously restrictive: using "your statement" instead of "this statement" or "we" instead of "the plan administrator." All but the bravest (foolhardy) will use the model verbatim. Indeed, look what happened when employers took the time, expense, and trouble to rework the government's model COBRA notice into something resembling English—they have been hit by a raft of class action lawsuits for "misleading" participants. Effort and resourcefulness are dangerous.

WILL THE SAVINGS NEEDLE MOVE?

Maybe, but just a little, teeny, tiny bit. Some people may increase their contributions when they notice how little their 401(k) balance will provide in monthly income. (They'll be lots of research on these effects of the new disclosure in a few years.) Perhaps, one out of a million participants may be nudged into considering whether to use a 401(k) account to buy a commercial annuity. But the new rules will not solve the "annuity puzzle" that makes folks extremely reluctant to exchange a pile of cash for a relatively small monthly lifetime payment. If Washington wants to meaningfully move the savings needle, it should enable universal savings plan availability with auto-enrollment, the only proven techniques for getting workers to save significant amounts.

The views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated.

David E. Morse
Editor-in-Chief
K&L Gates LLP
New York, NY