

Defaults for Distribution of Retirement Assets: What are the Issues?

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Abstract

This paper will focus on default distributions and covers the following topics:

- Why are defaults important?
- What are the risks to be considered?
- What are the realities with regard to the participants?
- What issues should be considered in setting a default?
- What are some possible options for a default?
- What are the perspectives of different stakeholders?

Introduction

As we focus on successful organization of the retirement income system in the future, it is very important to think about the payout period, and what is needed for successful benefit delivery and sustained income after retirement. During the time when many Americans were covered by traditional defined benefit plans, this was not a major issue, largely because these plans paid out monthly life income. Under the retirement system as it is evolving, fewer plans pay out monthly life income on a mandatory basis, so voluntary systematic management of the post-retirement period through annuitization or other options has become much more important. Although many people say monthly income is important to them, few people choose monthly income when given a choice of a lump sum. Choices are very important, and wherever there are choices, defaults are important.

This paper will deal with default options, relating them to the risks facing retirees, discussing methods of payout of plan benefits, and describing some of the challenges and barriers to the use of life income. It will offer perspective on post-retirement consumption levels, and then conclude with recommendations that could make life income more of a reality in the future. Consistent with the Retirement 20/20 approach, the paper includes an analysis of the perspectives of diverse stakeholders. As part of the Retirement 20/20 effort, this paper is written with the focus on thinking about the issues free from regulation. However, it also recognizes that regulations are a driver of the solutions used today and it discusses some of that influence. While the paper focuses primarily on the United States (U.S.) environment, the issues discussed have broader application.

The retirement system today and distribution options in Social Security, defined benefit (DB) and defined contribution (DC) plans.

U.S. Social Security benefits are paid as a life annuity indexed for inflation. Benefits are paid to workers, spouses and former spouses. For four out of 10 older unmarried women, Social Security is virtually all of the income they have. Social Security provides a base of life income to nearly all older Americans. Americans have no choice about the form of Social Security payment, but they have a choice about when to claim benefits. Benefits can be claimed between ages 62 and 70, and there is a large difference in the amount of monthly benefit depending on claiming age. Medicare benefits start at age 65, and they can be viewed as an indexed life income.

Social Security is supplemented by employer-sponsored retirement programs, other programs for building wealth in the employment context and personal wealth building. For most Americans, personal wealth is built through employer-sponsored programs and home ownership. In 2004, 58 percent of households headed by a person aged 45–54 had a tax-advantaged retirement account, as did 83 percent of those aged 55–64 and 43 percent of those aged 65–74.¹ Retirement plans have been much more prevalent in mid-sized and larger employers than in very small employers. Traditionally DB plans were the primary base layer for private sector retirement plans, but this has shifted so that DC plans are much more common. However, many people in the private sector continue to have DB coverage and DB remains very common for governmental employees.

Traditionally DB plans have paid benefits as life income with survivor benefits in the United States. It is common for plans to offer a choice of life only, life with survivor benefits and income with a certain period such as 10 years. A growing number of plans have lump sum options. In the U.S. private sector, a default option of a joint and survivor annuity for married couples, and a life annuity for single persons, is mandatory under current law. In the U.S. public sector, there is no such federal requirement, but payment of benefits as life annuities is very common.

Traditionally DC plans in the United States pay benefits as lump sums. Some offer installment payouts, life annuities or leaving the money in the plan as

options. Most benefits are paid as lump sums and then often rolled over into a tax protected account (an Individual Retirement Account in the United States).

U.S. law requires distributions from tax-protected retirement accounts according to “Required Minimum Distribution (RMD)” rules set forth in the tax code. The RMD has become the “default” distribution option for many people and for most of those with higher assets. For people who do not need to withdraw more than the RMD from their tax-sheltered account, withdrawing no more than the RMD maximizes the amount that will continue to be tax deferred. It is the author’s opinion that the existence of this requirement has encouraged people to assume that the RMD is the right method of distribution and not to think about annuity options and other methods of payment.

Defaults, options and mandates

Defaults and options can come in many different forms. They can be mandated or set at the option of the plan sponsor. The sponsors’ concerns include fiduciary liability, and one of the issues in setting a default is whether it generates any added liability or requirements. Defaults have gotten a lot of attention in the areas of auto-enrollment, increases in savings and investment options, but little attention has been paid to payout period defaults. Safe harbors are available in the U.S. for investment defaults but not distribution options. Here are a variety of default options for the payout period:

Mandated payment method—no choices are available—Social Security benefits use the default as the only option.

Mandated default option of life income, with the potential to offer choice of other options— like the DB structure in the United States.

Range of safe harbor choices that can be used as defaults—DC plan benefits are generally paid as lump sums. Plan sponsors could be permitted to offer a range of default options and be protected from fiduciary liability. Some of the possible ideas that have emerged for default options are:

- Lump sum
- Leave the money in the plan and apply an option like the default investment option for continued investment
- Life income—for all or part of the benefit with the possibility of spreading the conversion to life income into several installments

- Deferred life income with the conversion to income spread out over time and a total of 50 percent of the total account balance converted to a life income
- Two-year trial life income with a new election after the two years
- Life income including survivor benefits for spouse
- Mandate rollover into individual retirement plan, such as IRA in the United States
- Installment payout with a method of setting period for payout.

Mandate that certain options be included, but not that they be the default option—For example, a plan could be mandated to include an installment payment or life annuity.

Permitted choices—Legislation could specify range of permitted choices for payout options.

Open option—Permits any choice that an individual wants to make; the existence of an IRA rollover option in the United States is effectively an open option since it enables individuals to choose virtually any market payout option within a tax-protected plan.

The author is not aware of any organized evaluation of how these structures balance stakeholder interests and priorities that vary by person. The trade-offs are different for primary DC plans and supplemental DC plans. The legal structure puts DB and DC plans in the United States in a totally different starting position.

Drivers of payout decisions

We have learned in the United States that whenever choices must be made in DC plans, in health plans and in many other areas of life, the default option is a very powerful driver of behavior or a “Nudge.”²

The way that funds will be paid out may be based on system structure, individual choice, legal requirements or a combination of these. Influences on distribution and management include:

- Nudges and default options
- System and plan structure for applicable benefits
- Minimum required distribution regulations

- Overall level of assets and whether more retirement income is needed for basic expenses than provided by Social Security and pensions
- Advice provided by planners and advisors
- Taxes and ability to keep funds on a tax-preferred basis for as long as possible
- Risk management decisions
- Financial products available in the marketplace and their acceptance
- Investment structure chosen
- Family issues
- Expertise in managing investments
- Expense levels implied by options

Types of income streams and advantages and disadvantages to participants

A variety of different types of income streams can be provided. Exhibit I (on the next page) includes a range of choices.

The provider of the income stream may be an employer who provides the income stream through a pension plan, a multi-employer pension entity or a financial company such as a bank, insurance company or mutual fund. Where money is held in a pension plan or financial institution, there is some solvency risk. The solvency risk may be backed up by a governmental or third-party insurance arrangement.

Exhibit I
Types of Income Streams and Risk Distribution

| Option, Risk Distribution and Comments | Advantages | Disadvantages |
|--|--|--|
| <p><i>OPTION: A guaranteed life income for the life of the participant and spouse (or the participant only)</i></p> <p>Provider of income stream assumes mortality and investment risk, may assume all or part of inflation risk</p> <p>Individual assumes some solvency risk</p> <p>(Only choice in Social Security and default option in private sector DB plans and most public sector plans as well)</p> | <p>Income guaranteed for life—if inflation indexed, preserves dollar value in payments</p> <p>Larger income than other options because of “mortality dividend” (amount not paid to others who die early is redistributed to those who live long)</p> <p>Investment management responsibility transferred and in the hands of professionals</p> | <p>Lack of liquidity and inability to change decision later</p> <p>Option is locked in, can’t be changed later</p> <p>Generally no death benefit after second dies, so principal lost if both die early</p> <p>Potential for gain through good investment decisions is lost, but risk also transferred</p> <p>Cost of guarantees</p> |

| Option, Risk Distribution and Comments | Advantages | Disadvantages |
|--|--|---|
| <p><i>OPTION: Installment payments that allow for payment of principal and interest over time without any life or investment guarantee</i></p> <p>Individual bears mortality risk and investment risk; provider of income stream could guarantee investment return or minimum return and bear all or part of investment risk</p> <p>Individual may assume some solvency risk depending on financial institution used</p> | <p>Larger income than interest only and smaller than life annuity</p> <p>Unpaid balance after participant (and spouse or beneficiary if applicable) dies goes to heirs</p> <p>If good investment experience, funds can go up a lot</p> <p>Strategy can be modified later</p> | <p>Payments not guaranteed</p> <p>No mortality dividend</p> <p>Potential for outliving assets could leave people financially vulnerable in old age</p> <p>If funds invested in risky investments, payments can go down a lot if poor performance, and they will fluctuate over time</p> |
| <p><i>Option: Payment of investment earnings only</i></p> <p>Individual bears mortality risk and investment risk</p> | <p>Preserves capital for future needs, emergencies and heirs</p> <p>Strategy can be modified later</p> | <p>Smaller payments</p> <p>Depending on investments and distribution method, payments may be very unequal from year to year</p> |

| Option, Risk Distribution and Comments | Advantages | Disadvantages |
|---|--|--|
| <p><i>OPTION: Systematic withdrawal strategy</i></p> <p>Individual bears mortality risk and investment risk</p> <p>There are a range of such strategies—See Exhibit II below for description of several strategies</p> | <p>Smooths out payments if fixed amount, varying amount if based on paying percentage of varying asset base</p> <p>Can be designed to preserve principal</p> <p>Strategy can be modified later</p> | <p>May not work out well if poor investment results</p> <p>If withdrawals are too large, great chance of running out of money</p> |
| <p><i>Option: Home ownership—provides a means of reduced cash outlay to the individual</i></p> <p>Individual bears risk of change in value, need for repair, etc.</p> <p>While this is not a strategy to produce income, it is used in lieu thereof</p> | <p>Many people prefer to stay in their own homes in retirement</p> <p>Home is a resource that can be used as a form of “reserve for long-term care” with the potential for a sale, and as provision for a future bequest</p> <p>If home becomes unsuitable, it can be sold, but market may be very difficult</p> <p>Using house equity as an asset may offer way to minimize tax liabilities</p> | <p>Too much asset may be tied in home</p> <p>Home value may not be matched well to long-term care need, and for a couple, the survivor and healthy person will still need a place to live so using value as a way to provide for long-term care is very risky</p> <p>Individual may not have adequate means to live on</p> |

| Option, Risk Distribution and Comments | Advantages | Disadvantages |
|---|--|---|
| <i>OPTION: Home ownership – use reverse mortgage to convert value to cash</i> | Allows staying in home and getting some benefits of income | Disruptive if home needs to be sold |
| Could be packaged with lifetime guarantee | Product may include a lifetime guarantee | May be very expensive way of securing funds |

The strategies in Exhibit II provide a range of methods of planning systematic withdrawals. All mortality and investment risk remains with the individual. These methods can be used by individuals managing their own assets, or with an advisor. None of them specifically take into account changing needs over time.

The only one of the systematic withdrawal options that is effectively used as a default is the RMD.

Exhibit II
Examples of Systematic Withdrawal Strategies

| Spending rule | Example |
|----------------------------------|--|
| Simple % of \$ spending rule | Withdraw 3% of assets per year Withdraw \$500 per month |
| Endowment-like rule | Withdraw 5% of average of three prior years' asset value |
| 4% or 4.5% rule | Spend 4% or 4.5% of total retirement savings in first year of retirement. Increase dollar amount by inflation rate each year thereafter. |
| Monte Carlo or other simulations | Model withdrawal rates simulating effects of changing investment returns; adjust spending accordingly |
| Tax-sensitive withdrawals | First withdraw assets from Roth savings or taxable assets subject to preferential capital gains tax rates. Postpone taxable pre-tax withdrawals. |
| RMD withdrawals | Spend only required minimum withdrawals from IRAs and other retirement plans once age 70.5 |

Source: Mottola, Gary R. and Steven P. Utkus, "The Retirement Income Landscape," Volume 34, December 2008, The Vanguard Center for Retirement Research, page 6.

Risks

There are several risks that retirees are subject to. Exhibit III draws heavily from the risk analysis developed by the Society of Actuaries in conjunction with the 2007 Risks and Process of Retirement Survey.³ The survey provides information about how retirees view these risks and what is most important to them. This survey series and focus groups conducted by the Society of Actuaries indicate that there is considerable misinformation about risks and that in addition to the misinformation, many people do not think long-term, even when planning for retirement. The focus groups were titled “Spending and Investing in Retirement—Is There a Strategy?”⁴

Exhibit III
Risks Facing Retirees and Comments about Their Management

| Risk | Products and Approaches for Risk Transfer and Potential for Pooling | Comments |
|------------------|---|--|
| Outliving assets | <p>Annuities, including joint and survivor annuities and deferred annuities commencing at higher ages such as 85 (longevity insurance)</p> <p>DB plans often automatically provide life income.</p> <p>Risk transfer not needed if investment income without using assets exceeds expenses</p> <p>A few inflation adjusted annuities are available, and annuities without inflation adjustment provide only partial protection.</p> | <p>Consideration of both spouses is needed in designing a strategy.</p> <p>At age 65, average life expectancy is 17 years for American men and 20 years for women. Thirty percent of all women and almost 20% of men age 65 can expect to reach age 90. (Source: U.S. Life Tables)</p> <p>Bond ladders offer other strategies to produce long-term income, but not income guaranteed for life.</p> |

| Risk | Products and Approaches for Risk Transfer and Potential for Pooling | Comments |
|---|---|--|
| Loss of spouse | <p>Joint and survivor life annuities, life insurance</p> <p>Long-term care insurance helps protect assets that may be left to spouse.</p> | For women, periods of widowhood of 15 years and more are not uncommon. |
| Cost of disability and long-term care | <p>Long-term care insurance</p> <p>Continuing care retirement communities</p> <p>Medicaid pays for cost for many people without assets or income.</p> | <p>Nursing home costs can exceed \$70,000 per year today.</p> <p>Care can be provided at home, in an assisted living facility, adult day care center, or nursing home.</p> |
| Cost of acute health care | <p>Medicare</p> <p>Medicare supplemental insurance including employer-sponsored retiree health benefits</p> | |
| Investment risk, inflation and interest rate risk | <p>Investment strategies can reduce risk; some products provide minimum guarantees</p> <p>Inflation protected bonds</p> <p>Annuity products with cost of living adjustments</p> | |
| Inability to find job, loss of job | No way to pool on a longer-term basis | |
| Family members needing care | No way to pool | |

Several of the risks shown in Exhibit III can be pooled and transferred, except for inflation risk. There are other risks that are much less subject to risk transfer and/or pooling. These include the inability to find a job and premature retirement risk. About 40 percent of Americans end up retiring before they had expected to, often because of job loss, poor health or family issues.

The major concerns of retirees and pre-retirees were documented in the 2007, 2005, 2003 and 2001 Society of Actuaries Risks and Process of Retirement Surveys. Key findings of the surveys included the following:

- Pre-retirees are much more concerned about risk than the retirees
- There has been little change in the retiree perceptions about risk over the years
- Pre-retirees became more concerned between 2001 and 2003, not surprising in light of the terrorist attack in New York and the poor equity markets, but they have reduced their concern from 2003 to 2007
- Inflation and medical costs were the biggest risk concerns in the past. It is unclear what they will be in the future.
- Outliving assets is not a big issue

The conclusions reached in the survey results are consistent with many other information sources indicating misinformation about risk and low risk awareness. It complements well the information on how individuals make choices as reflected in the work of financial economics.

Investment knowledge

Studies of knowledge about investments also show misunderstanding. From their responses to basic questions as to how investment vehicles work, the public appears poorly prepared to assume the management of retirement assets. Default options are taking an ever-increasing role of importance in the management of DC plan assets. Default options have evolved in the last few years and new regulatory requirements have opened the way to greater use of automatic enrollments and different investment defaults.

A useful perspective of the public's knowledge of investments can be found in the John Hancock Life Insurance Company's 2004 study in the series, *The Insight into Participant Investment Knowledge and Behavior Study*. This is the ninth in a series of surveys that started in 1992. Respondents to that survey all participated in 401(k) or similar plans that gave them investment choice, so all have some exposure to investments, but many show significant gaps in their knowledge of investments and confusion about how investment vehicles work, their relative risk and what they include. Survey respondents were unclear about the features and risk profiles of many investment vehicles common to employer-sponsored plans.

For example, participants were confused about the relative risk of company stock. When asked to rank the risk of various investment options within their employer-sponsored plans, in all nine surveys, respondents ranked their company's stock as less risky than diversified domestic stock funds or diversified global stock funds. Unfortunately, familiarity with the employer, combined with the loyalty of the employee, may lull the participant into a false sense of security regarding employer stock as an investment. The 2004 survey results did not seem to be influenced by widely reported corporate scandals at Enron and other firms that led to bankruptcies or many losses in stock values in recent years.

As another example, the participants did not understand what a money market fund is. When asked what types of instruments are found in a money market fund and allowed multiple responses, 48 percent said short-term investments, 47 percent said bonds, and 43 percent said stocks. Only 9 percent knew that money market funds contain only short-term investments.

In addition, most participants do not understand how bonds perform in changing investment markets. Specifically, they do not understand that the market value of a bond moves inversely with changes in external interest rates. In the Hancock's 2004 survey, more than three-quarters, 77 percent of respondents, did not know that the best time to invest in bonds is prior to a decrease in interest rates.

Over time, the level of misunderstanding has been consistent since these questions were first posed in 1992. Since all respondents to these surveys were participants in an employer-sponsored DC plan, and therefore had some investment experience, the average American is probably even less well educated than suggested by the results to this series of surveys.

Investment decisions by individuals who retired with DC account balances

A 2008 Investment Company Institute survey⁵ provides insights into how households are using their accumulated balances. The median household financial assets of this group were \$336,100, and 38 percent had \$500,000 or more. The median age was 65. The study looked at what they did and what they said about what they did. Seventy percent of the respondents reported having a choice of distribution option, and 30 percent reported that they had no choice.

The disposition of the accounts was reported as follows:

What Happened to DC Accounts at Retirement

| | |
|---|-----|
| Multiple dispositions | 9% |
| Lump sum, spent all | 7% |
| Lump sum, spent some, reinvested some | 11% |
| Lump sum, reinvested all | 34% |
| Deferred distribution of entire balance | 16% |
| Installment payments | 6% |
| Annuitized entire balance | 18% |

Source: Figure S.1, Defined Contribution Plan Distribution Choices at Retirement, Fall 2008, Investment Company Institute.

For amounts greater than \$100,000, more than 30 percent of the balances were annuitized and more than 45 percent were reinvested. The study offers insights into which types of respondents made different choices and why. Some of the comments made in the report include the following:

“The few retirees who spent their entire DC plan lump sum distributions generally had received small balances.

Retirees who received their distributions through either annuity or installment payments expressed a desire for regular income as their primary motivation.

Retirees with sizeable household financial assets and income typically postponed use of their plan balances either by reinvesting the assets in Individual Retirement Accounts or deferring their distributions.

When DC plan participants have more than one option for the disposition of their plan balances at retirement, they generally make thoughtful decisions.”

This study does not tell us how successful the decisions were in the long run and the author is not aware of such data. That is, we do not know how well people who retired with DC balances fared 10, 15 and 20 years after retirement. A particular area of concern is also how widows fared, as there are many older widows and there is often a decline in economic status at the time of widowhood.

Taxes and default options

One of the important factors in the structure of retirement programs is taxation. Tax advantaged programs can offer:

- Immediate taxation (T) or tax deferral (E) on the contributions
- Immediate taxation (T) or tax deferral (E) on the investment earnings
- Taxation (T) or no taxation (E) on withdrawals or benefit payments

401(k) plans and traditional individual retirement accounts in the United States offer deferral of taxes on contributions and investment earnings and full taxation at the time funds are removed from the plan (EET). Roth IRAs provide for after-tax contributions, and no taxation on investment earnings or benefit payments (TEE).

Taxes can be a challenge when one thinks of default options. It is not desirable for taxes to become the main driver of action, but at the same time, one would not want to use a default option that produces a bad tax result.

Role of the RMD

In the United States, tax deferred funds can be continued on a tax deferred basis after retirement, with withdrawals required to be made on the basis of the RMD rules starting at age 70.5. These requirements are based on life expectancies, and require a withdrawal equal to the starting balance divided by the life expectancy. Different tables are used based on marital status and for beneficiaries.

Some examples of the amount that must be withdrawn are as follows:

| Age | Unmarried Owners* | Beneficiaries |
|------------|--------------------------|----------------------|
| 71 | 3.8% | 6.1% |
| 75 | 4.4% | 7.5% |
| 80 | 5.3% | 9.8% |
| 85 | 6.8% | 13.2% |
| 90 | 8.8% | 18.2% |

* Also includes married owners with spouses not more than 10 years younger

Larger amounts may be withdrawn. If investment income and asset growth combined exceed the amount withdrawn, funds will continue to grow. If assets

decline, the withdrawals will accelerate the decline. The key point of this discussion is that for individuals with a mix of tax-deferred and other funds, the tax rules tend to drive from which source withdrawals are taken, and may encourage not focusing on making funds last a lifetime or the need for guaranteed income. Of course the withdrawal from tax-protected funds does not require that these amounts be spent.

A recent report from Vanguard models RMDs as an income strategy assuming \$100,000 in an IRA at age 70.5 and a 3 percent real rate of return. These results assume that the RMD is spent each year, and show an initial RMD of \$3,800 increasing slowly to \$5,300 at age 89, and dropping off at age 90. The report comments *“RMD withdrawals from IRAs or DC plans, while essential to comply with tax laws, may not be a sustainable strategy for generating a predictable retirement income. At the margin, they can be a simple way to generate some income. But for those who live a long life, there is the risk that the RMD income level falls sharply in one’s 90s. And portfolio income can be volatile depending on how the underlying assets are invested.”*⁶

If we consider the potential that major portions of tax-protected funds are a contingency fund for items such as unexpected health care, home repairs and long-term care, the RMD requirements partly interfere with preserving them for that purpose.

Where housing fits in

Owning housing can be viewed as a personal risk management technique. While it has risks, it can be thought of as cutting across different risks:

- Having a fully owned house is somewhat like an annuity since ongoing living costs are lower than if one has to pay rent or make mortgage payments.
- It is a form of long-term care protection since the house can be sold if long-term care is needed. Similarly it can be sold for other major emergencies.
- It is a way to preserve value for a bequest, either for a spouse or other heirs.

This discussion may seem out of place in a paper about distribution options and pensions, but because housing is a major part of wealth, it is important to consider in thinking about these issues.

Stakeholders in retirement benefit delivery and their interests and priorities

Several groups of stakeholders interact within the delivery system producing retirement income. The stakeholders are (1) individuals whose benefits are often driven by defaults, (2) employers who sponsor plans, offer defaults and access to group purchase of products, (3) the financial services industry and (4) regulators. These groups interact and influence each other. However, to be consistent with the basic framework for Retirement 20/20, regulators are not discussed in this paper.

The individual perspective

As the individual thinks about retirement resources during the period that they are being used, a portfolio approach is needed. Social Security is in the form of life income, and added DB benefits might also be. The main concerns of employees include:

- When to retire
- Dealing with confusion
- Managing money in retirement
- Being able to deal with emergencies
- Leaving money to heirs
- Making money last
- Not losing money.

For retirement resources in excess of Social Security and DB income, there are choices and a variety of trade-offs:

- Guaranteed income can be secured in exchange for giving up liquidity, control of assets and potential to leave money to heirs
- Costs for annuities are viewed as high
- Liquidity is highly valued as is control
- Equities are traditionally expected to yield a higher return in the long run in exchange for greater risk, but of course they also have potential for big declines
- Inflation protection can be included in annuities but at the price of a big reduction in income.

The barriers to retirement income vs. self management of assets from an individual perspective include how individuals think about the issue, lack of

flexibility once an annuity is purchased, the availability of resources to purchase guaranteed income, and the tendency to be over-optimistic about how long self-managed resources will last as well as to underestimate how long they will be needed. Lack of flexibility once an annuity is purchased is a major issue and barrier to purchase. It leads to the need to think about how much of the portfolio might be used to buy annuity income. The entire portfolio should not be annuitized.

Key findings that help us understand how individuals think about risk and its relationship to retirement resource management include:

- Default options are very powerful.
- The focus of many individuals (and their advisors) is on investment management, not risk transfer or risk management.
- The planning horizon is very short for many people and the approaches that are used to think about retirement tend to be intuitive and not based on sophisticated analysis. In fact, sometimes they do not involve any quantitative analysis.
- Reducing spending is the most popular risk reduction strategy.
- Control of assets is an important issue, but at the same time many people are not able to exercise the control well.

Population analysis provides insights into which population segments are most affected by the structure of default options and DC distribution alternatives:

- At the lower end are people with little in the way of financial assets and income beyond Social Security and Medicare. They are heavily annuitized and do not have much in the way of assets. The structure of DC plans will not have impact on this group until they build assets in DC plans.
- At the high end are people who have investment income that more than covers their regular expenses. They do not need to purchase guaranteed income. Maximizing estate values is often a priority, and for this group, the RMD is likely to be their personal default option for withdrawing DC funds. This is an argument for making income-based arrangements defaults or options, but not mandatory.
- It is the group in the middle that will be most affected by the distribution options and defaults included in DC plans. This group has DC and other financial assets and they need retirement income. They risk using assets too fast, so they have difficult decisions and trade-offs to make with regard to the distribution of their DC assets. Without the right distribution

options, members of this group may end up with little beyond Social Security as they reach higher ages.

As new distribution and default options are structured, it is important that they work for people in a range of circumstances.

The discussion of risks provides an indication of the lack of public knowledge about risks and of public perceptions. Focus group research provides additional insights. Focus groups conducted for the Society of Actuaries in 2005 provide perspectives on how individuals view retirement issues and challenges. Following are some key points from the focus groups that looked at how retirees with moderate assets are investing their funds are:

- Retirees tend to plan on a short-term and not a long-term basis.
- It is common for retirees to take 6 percent of assets and compare to expenses (less income from other sources) and use this as a measure of affordability of retirement.
- Most of the retirees did not have an organized comprehensive risk management program. Rather they took each day at a time and dealt with things as they occurred.
- Many of the retirees did not do formal retirement planning.
- There was a lot of awareness of long-term care insurance, but few bought it, and a number thought it was too expensive.
- There was very limited awareness of annuities.
- A lot of what people think they know is often misguided or false.

The big challenge is getting people to plan in an effective way. Individuals who do not plan very well are not focused on the myriad issues involved in delivery.

The full report of the focus groups and the 2007 Risks and Process of Retirement Survey can be found at www.soa.org

The employer perspective

The next stakeholder to consider is the employer. Traditionally employers offer income through DB plans, and there are no special problems to focus on. However, most DC plans only offer lump sums and not life income, and as these plans are growing, it is important to consider issues surrounding life income in DC plans. As these plans have evolved, they are more often the primary retirement vehicle, and in the last decade there has been a growing focus on results produced by these plans. For instance, default options are now recognized as critically important, since many employees stay with them and do

not make an active choice. Common defaults today include auto-enrollment, auto-increases and investment defaults using balanced and lifetime funds. It is uncommon to find distribution defaults other than a lump sum. This is an area for further development. Major concerns of the employer with a primary DC focus today include:

- Helping employees realize the benefit of the funds they have accumulated
- Secure retirement for employees
- Fiduciary liability
- Winning loyalty and appreciation from employees
- Supporting talent management policy
- Keeping administration simple and cost effective

The distribution of benefits and making funds last during retirement are important issues in achieving success and meeting plan goals. Satisfactory results post-retirement will depend on having good methods for providing advice and life income to employees and retirees in an efficient and unbiased manner. Employers could play a key role in selecting the providers that would offer group products for risk protection through the employer. Default options are critical in structuring plans.

Plan sponsors are reluctant to offer annuity options directly because few people choose them. In addition, regulatory issues in the United States such as joint and survivor annuity and spousal consent requirements, “safest annuity rule” issues, and/or fiduciary responsibilities, etc. create more work and uncertainty. It should be noted that the regulatory climate discourages employers from offering life and other income options. The employer who offers only a lump sum option does not need to get spousal consent for plan distributions. In contrast, the employer who offers an annuity option must offer a joint and survivor annuity and must get spousal consent in order for someone to elect out of the option. One of the other complexities is that annuities are usually priced using different rates for males and females, but employers are prohibited from using sex-based rates or features inside of DC pension plans. A third complexity is the minimum distribution rules. The most desirable form of annuity option would be one that allows purchase in several chunks over time, but the minimum distribution rules fight against this. The safest annuity rule also opens the employer up to fiduciary liability.

Instead of offering income directly through the DC pension plan, companies such as IBM are beginning to offer annuity options outside of the plan but with institutional pricing through a third-party IRA rollover program. Under one

third-party program now being used by some large companies, the annuity is shopped using an automated process to get a good price, it can be purchased at retirement or later, and in steps over time. A group of employers is also working on an annuity purchasing coalition using institutional pricing of the product. Note that the Pension Protection Act opens the way to an easing of the safest annuity rule issues. Working through the employer is one way to deal effectively with the distribution system issues. It will, however, have a chance only if the regulatory issues are dealt with to make it easier.

The perspective of the financial services industry

The financial services industry includes banks, insurance companies and advisors. They support the distribution of assets from retirement plans by offering products and services to the plans directly, by offering roll-over IRA and other individual products, and by offering advice. These products and services offer the individual options for guaranteed life income, regardless of what the employer does.

Providing products and services for the post-retirement period is viewed as a very important opportunity by many people today. They range from savings and investment funds and products, to distribution products from mutual funds to immediate annuities. Sales of immediate annuities remain low.

One of the big issues is whether services are provided with the sponsorship of the plan sponsor or directly to individuals. Cost is an issue from the perspective of various parties, and when custom service is provided to individuals, it can be quite expensive.

The choices that the individual must make are complex. Some choices lock the individual in; others can be changed later. The range of products is growing and they involve trade-offs. There are also issues surrounding the design and cost of the product. Buyers would prefer a product that does not require an immediate irrevocable choice, and various alternatives are being explored. In addition, inflation protection is very expensive, and there are few inflation-protected products. In order to really protect life income, inflation protection is necessary; so many products only do a part of the job. At the same time, the insurer needs to be able to match investments to minimize its risk, and there are relatively few inflation-protected investments to match the liabilities. Another challenge around product design has been getting a risk pool that includes a good spread of risk. If only very healthy people buy annuities, that drives up the cost of the product and further reduces sales. Producing products that combine some long-

term care coverage with annuity income will reduce anti-selection and change the risk pool. The example below includes a caregiver benefit. This idea has been discussed in various settings, but such products are subject to regulatory difficulties and are not popular. This idea deserves further study and development. Another issue relates to the types of guarantees and their cost. The buyer wants guarantees, but does not necessarily recognize their value and may not be willing to pay adequately for them. Exhibit IV illustrates how the amount of annuity income can change for example situations as more features and guarantees are added to the product. The caregiver benefit pays a higher income if the individual becomes incapacitated.

Exhibit IV
Illustrative Monthly Annuity Income
Initial Income as of July 30, 2006 for \$100,000 Rollover – Male 65 and 75

| Sex and Age of Annuitant | Form of Income | Monthly Income | Annual Income as % of Initial Payment |
|---------------------------------|--------------------------------------|-----------------------|--|
| M65 | Level Life Only | \$662 | 7.9% |
| M65 | COLA Life Only | 489 | 5.9% |
| M65/F62 | COLA, 75% Survivor | 407 | 4.9% |
| M65/F62 | COLA, 75% Survivor and 50% Legacy | 395 | 4.7% |
| M65/F62 | COLA, 75% Survivor and 50% Caregiver | 369 | 4.4% |
| M75 | Level Life Only | 897 | 10.8% |
| M75 | COLA Life Only | 723 | 6.7% |
| M75/F72 | COLA, 75% Survivor | 567 | 6.8% |
| M75/F72 | COLA, 75% Survivor and 50% Legacy | 542 | 6.5% |
| M75/F72 | COLA, 75% Survivor and 50% Caregiver | 496 | 6.0% |

Source: Paper presented at the Future of LifeCycle Saving and Investing in 2006 by Jerry Golden, President, Income Management Strategies Division, Mass Mutual Financial Group.

This table makes clear that for those who buy an annuity, there are significant trade-offs depending on the provisions chosen. There are even greater trade-offs between financial strategies not involving annuitization.

Innovative ideas under consideration in recent years include mutual fund payout products, annuities that offer various guarantees, combination products, longevity insurance, new coverages, reverse mortgages and others. As with other financial products, tax structures as well as need drive the product structures. The minimum distribution rules are often cited as one of the barriers to product innovations.

We can think about barriers and challenges from the perspective of the financial services company in several different ways. There are different sets of issues relating to the design of products and the willingness of consumers to buy them, relating to the distribution system and the willingness of insurance agents to sell them, and risks relating to the financial structure of the products and their guarantees.

Looking at the future: The author's recommendations

Managing resources and income in retirement is a very important part of the total retirement income picture for the future. Retirees face many risks, often without perfect solutions or enough resources to address them all. Defaults are an important influence whenever people act. A multi-pronged approach looking at the role of the employer, the nature of products, the education of the individual and the regulation of all of this is needed to secure a better future.

1. Rethink default distribution options in DB and DC plans—while DB plans pay income, today lump sums are the common default in DC plans, and life income options are often not available. While there has been a great deal of innovation in plan design over past decades, there has not been much innovation in payout management. As discussed earlier in the paper, there are a range of payout period possibilities including options and defaults. Much discussion is needed to reach consensus on what should be allowed, what should be required and what should be protected in a safe harbor.

I personally would prefer to see an income-based default distribution that leaves the money in the plan for a period after retirement and provides for paying out a modest regular installment during the interim. Then, at an age such as 70 and for each of the next four years, annuitize 10 percent of the balance on a 100 percent joint and survivor basis. The retiree would be able to opt-out of this default option for any funds not yet annuitized. The advantages of this option include:

- Giving participant time to think about irrevocable decisions

- Allowing the participant to experience the annuity gradually
- Forcing individual to consider an annuity
- Dollar cost averaging
- Thinking about distribution options from portfolio point of view.

Placing high priority on distribution options and recognizing the realities of participant needs and preferences, as well as barriers in the world today are essential to making progress.

2. Unify and rationalize the regulatory environment—while this paper is not about regulation, it is clear that good ideas will not work without a reasonable regulatory environment. With pensions regulated in the United States by the IRS, DOL, PBGC, FASB and sometimes the SEC, and annuities regulated by state insurance departments and sometime the SEC, there is a huge mass of complicated regulations that governs annuities and pensions. In addition to regulating the employer and the financial services company, income tax rules impact when it is attractive to use a risk protection product and when not. They complicate what would otherwise be rational strategies. Unified and balanced regulation would be important to opening the way for simple and logical solutions.

3. Restructure or eliminate RMD requirements so that they are more supportive of guaranteed life income.

4. Education

It is clear that many individuals do not make well-informed choices about their retirements and the management of money post-retirement. The trade-offs involved in the choice of a strategy are extremely important, and not easy to understand. Better information is needed for all concerned about the range of options available and the trade-offs implied by choices. It should also be remembered that some choices are irrevocable when made, while others can be changed later.

5. Support financial product innovation

Financial products work together with employer-sponsored plans to offer the public vehicles for managing assets in retirement. A number of ideas for innovation have surfaced, and the products described here are offered on a limited basis in the market. Some of them are complex to offer in light of existing regulations. Ideas for further development and innovation include:

- Combination annuity and long-term care product offerings: From the point of view of managing risks, it would be ideal to combine various product offerings, or offer them as a holistic package. As such, they could be priced more effectively and would help people manage multiple risks through a single product purchase.
- Offer special annuity products for people in poor health. This would be another way to capitalize on risk characteristics.
- Longevity insurance: This is a deferred annuity (without cash values or death benefits on early death) that pays benefits starting at a high age such as 85.
- Further development of reverse mortgages and other programs to use housing wealth. Evaluate these alternatives and compare to other options to provide guidance to help people understand when they are most likely to be effective.
- Unbundled retirement annuities parallel to universal life: Universal life unbundles life insurance by separating out the accumulation amount and the cost of mortality. An annuity can be unbundled by setting up as an accumulation account, and adding a “dividend” to reflect the value of survivorship. That is, the amount of accumulation for those who die is redistributed to those who continue as participants. This would help open the way to other innovations.

6. Integrate perspectives: Remember that the needs of different stakeholders interact.

As we think about new approaches, some of the key questions include:

- What is the appropriate time for choice of income and should it be guaranteed?
- Should it be on a joint and survivor basis?
- Should there be any way to get a refund or change option later?
- How much of the portfolio should be annuitized?
- How should spouses be protected?
- How does this fit into the total portfolio?

- How can we integrate the best approach to provide income with federal requirements regarding minimum distributions?
- What should be the role of the employer in helping?
- What are the best sources of advice and how do we find them?

Responses to these questions will help us evaluate new approaches and fit them into evolving programs.

¹ Mottola, Gary R. and Steven P. Utkus, “The Retirement Income Landscape,” Volume 34, December 2008, The Vanguard Center for Retirement Research, page 2.

² Richard Thaler and Cass Sunstein, “Nudge: Improving Decisions About Health, Wealth, and Happiness.”

³ Society of Actuaries, 2007. The reports from the risk survey can be found at <http://www.soa.org/research/pension/research-post-retirement-needs-and-risks.aspx> . (Note that there are five separate reports—a full report on the survey and four reports that focus on specific portions of the results.)

⁴ Society of Actuaries, 2004. The reports from the focus group can be found at <http://www.soa.org/research/pension/research-post-retirement-needs-and-risks.aspx>

⁵ Defined Contribution Plan Distribution Choices at Retirement, Fall 2008, Investment Company Institute.

⁶ Mottola, Gary R. and Steven P. Utkus, “The Retirement Income Landscape,” Volume 34, December 2008, The Vanguard Center for Retirement Research, page 7.