

# The Role of Information and Expectations in Retirement Planning: Communicating Income versus Lump Sums

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## **Abstract**

In defined contribution plans, it is most common to provide lump sums as the primary form of payment and to communicate plan benefits as lump sums. We know from research that people tend to be short term focused and that they do not translate lump sums well into income. We also know that there are gaps in understanding and financial literacy.

This paper will discuss information and the signals it provides and focus on the issue of communicating lump sums versus income. It will discuss challenges in communicating income and provide some alternatives. The author will bring in some of the information from her ERISA Advisory Council testimony on financial literacy and what employers should tell employees about the post-retirement period and some of the research. The paper will also introduce family issues and the need to communicate about how savings affect all family members.

## **Introduction**

This paper focuses on the need to communicate income as well as lump sums, particularly in defined contribution (DC) plans. It discusses the potential to provide signals through plan structure as well as messages provided. It offers recommendations.

The paper deals with the situation in employer-sponsored DC plans and the employer/plan sponsor relationship with the participant. There are other situations where there are parallel issues, such as the income equivalent of the balance in an individual retirement account (IRA). These situations are beyond the scope of this paper.

The following topics are covered:

- The situation today
- Realities—income alternatives and products, what people know and the family
- Link of financial literacy and signals regarding income versus lump sums
- What one plan sponsor has said
- Default options, inside the plan options and signals
- What employers/plan sponsors can do
- What employers should do

- A practical solution.

## **The Situation Today**

Pension plans were established as income replacement and to help people retire in an orderly fashion. Early plans focused on retirement income, but in recent years, with new forms of defined benefit (DB) plans and the spread of primary DC plans, many participants have a choice of a lump sum or income, even for their first layer of benefits over Social Security.

In DC plans, the usual form of benefit and the common expectation is that the benefit will be available as a lump sum, and usually it is paid that way. In the United States, many participants roll the lump sum into an IRA in order to preserve continued tax deferral. While the employee is working, the information provided about the plan almost always includes the account balance as a lump sum. It is not very common for the information to also include the equivalent amount of monthly income, or to focus on the need to use the funds to replace a regular paycheck.

DC plans can be primary or supplemental. Where they are primary, they represent the main (or only) form of employer-sponsored cash retirement benefit. Where they are supplemental, the employer provides a first layer of benefits over Social Security, generally in the form of an income-based DB plan. The discussion here applies to primary DC plans. There are additional issues to think about when applying it to supplemental plans.

The question has been asked: “What is the right amount of lifetime guaranteed retirement income that someone should have as a minimum?” There is no established and generally accepted guidance on this matter. It is generally agreed that someone who is spending most of his income before retirement and wants to maintain the same standard of living will need to spend about 70% to 80% of pre-retirement income in the usual case. This percentage could be greater if there are medical benefits before retirement and not after and for people with interests in special activities and travel. It could be much less for families that spent a lot of their income on raising children, or who recently paid off a mortgage. But this guidance does not speak to guaranteed lifetime income. It simply looks at spending pre- and post-retirement and does not reflect inflation or changing needs during retirement. Experts disagree about whether any guaranteed life income beyond Social Security is needed, and about the

desirability of purchasing annuities versus investing assets and using them as needed.

The author believes that conceptually it would be very desirable to show the participant two types of information—regular income at retirement and, in addition, the lump sums. On the surface this sounds easy, but a number of questions have to be answered:

- At what age will the income start?
- How much money will be earned on the account balance from today to the income start date?
- If the plan does not provide the income directly, what will be the basis of conversion to the income?
- How will the income amount be kept up-to-date given that there is an ever-changing market?
- By monthly income, do we mean guaranteed for life? Do we mean guaranteed for the life of the employee and spouse? What percentage of the benefit should be paid to the spouse?
- Will the income be indexed for inflation, a stated percentage increase or be a level amount?
- If the income is to start in 20 years, how will we help the participant translate dollars of purchasing power?

These examples of questions show us that we have many decisions to be made before we can illustrate life income and that this is not an easy task. And in addition, if we illustrate income at age 65, the employee might want to know about income starting at 62 or 68.

## **Realities: Where We Are Today and What We Have Learned from Research**

Income alternatives and products: There are a wide range of different market solutions for investing and income in retirement ranging from simply investing and withdrawing the money to a guaranteed income. (Note: where the term annuity is used here, it refers to a guaranteed income payable for life, whether provided through an insurance contract or not. The amount may vary or not.)

Here are some key facts:

- In the United States, DB plans offer income directly in the retirement plan and traditional plans define benefits as income, but DC plans generally do

- not offer income within the plan. If guaranteed income is desired, it needs to be purchased outside of the plan. DB plans in the private sector are required to have joint and survivor income as the default option at retirement, and spouse consent is required to opt out of that income form. DC plans are not required to offer a life income option, but if they do, then spousal consent is needed if a joint and survivor income is not selected.
- Products are now available to the plan sponsor to enable year-by-year DC contributions to be used to purchase deferred annuity income. These are being promoted for use for the match in DC plans that offer an employer matching contribution.
  - Individuals can choose to take market risk in exchange for an expectation of higher investment returns—this can be done with or without a life annuity guarantee. Variable annuities offer a combination of investment control, market risk and guaranteed income for life.
  - Payout products include those that provide a refund of unpaid balances and no lifetime guarantee and those that include a total lifetime guarantee and no balance at death. They may offer a range of investment options.
  - There are a number of features and guarantees available within the products on the market and guarantees always have some price attached to them.
  - Annuity purchase can be on an individual basis or a plan sponsor can arrange for group purchase, possibly through an IRA with competitive pricing. Where the plan sponsor uses group purchase, there is a significant price advantage.
  - In today's market, some financial service firms provide automated annuity estimates or quotations. For example, Fidelity's Web site was used for the estimates in Exhibit I.

The bottom line is that there is a trade-off—the smallest income if you choose to use investment earnings only and preserve the principal, more income if you choose to use the principal over time but preserve the right to get a return of unused principal, and most income if you use the principal to provide income guaranteed for your life, but with no return of principal. In contrast, the purchase of a fully guaranteed life income means that the purchaser surrenders control of the asset and flexibility to move into another strategy later. Exhibit 1 offers some examples of the trade-offs (based on June 7, 2008 annuity quotes from the Fidelity Web site). For a lump sum of \$200,000, a 4 percent per year payout will yield an initial monthly income of \$667, compared to a life annuity of \$1,990 per month for a 75-year-old male. The \$667 will fluctuate, or if there is a fixed \$667 payout, the balance in the investment account may not keep up with inflation,

and it could even decline; under extreme conditions, the account could be used up. If the 75-year-old has a 70-year-old wife, they could get \$1,416 per month as long as either lives. The \$1,416 drops to \$1,281 if payments are guaranteed for 20 years. Exhibit 1 shows a few more examples. The key point is that there are trade-offs based on the type of payment, whether payments are guaranteed for life and whether there are death benefits. It is also important to note that a different balance can be achieved by using a combination of approaches. For example, one could decide to devote 25 percent of one's assets to guaranteed life income, and another 25 percent to income where the expectation is long payout but where there is a return of funds on death and no lifetime guarantee. The trade-offs are more complex with a range of product features, and the relative price of the options depends on your age, what products you use and what is guaranteed. The decision to convert principal to guaranteed income or regular, but not guaranteed, income can be made at many points in time and in steps. The author hopes that the employer will play a role in helping people to understand the options and trade-offs.

**Exhibit I**  
**Understanding the Trade-offs\*\***

		Lump sum	\$200,000			
Age of male	Age of female	Form of income paid	Monthly payment	Payment to survivor	Minimum total payout	Notes
		Pay income out at 4% per year (4% is intended to be a safe payout*)	\$667	\$667	NA	Principal not committed to annuity* Can change mind about arrangement at any time
		5-year installment payout	\$3,586		\$215,160	Payments for fixed period
		10-year installment payout	\$2,077		\$249,240	Payments for fixed period
65	60	Life income with 100% payment to survivor	\$1,174	\$1,174	NA	
		Life income with 100% payment to survivor and 20-year min. payout	\$1,155	\$1,155	\$277,200	Payments are paid for at least 20 years
		Life income with 50% payment to survivor	\$1,349	\$674		
		Life income with 50% payment to survivor and 20-year min. payout	\$1,215	\$607	\$145,800	Payments are paid for at least 20 years
65	NA	Life annuity only	\$1,464	\$0	\$0	No payments made after death
75	70	Life income with 100% payment to survivor	\$1,416	\$1,416	NA	
		Life income with 100% payment to survivor and 20-year min. payout	\$1,281	\$1,281	\$307,440	Payments are paid for at least 20 years
		Life income with 50% payment to survivor	\$1,753	\$876		
		Life income with 50% payment to survivor and 20-year min. payout	\$1,312	\$656	\$157,440	Payments are paid for at least 20 years
75	NA	Life annuity only	\$1,990			No payments made after death

Note: Annuity quotes are based on Fidelity Web site and quotes made on June 7, 2008. Web site indicates that quotes can change daily.

\* It should be noted that the 4% payout will vary as asset values vary, and that it is not totally safe. Under some scenarios, if asset values go down, principal will go down, and while the intention may be to preserve principal, it does not always work out.

\*\* Taxes are not considered in this exhibit.

What people know and how they act: Research has repeatedly shown significant gaps in knowledge about retirement. The author's synthesis of these findings is that:

- Americans lack financial literacy. Many do not understand basic math including compound interest and percentages. The tools to understand time value of money and translate income into lump sums and vice versa, and plan over the long term are beyond the grasp of very large segments of the population.
- Lump sums are over-valued when compared to the present value of an equivalent income stream. The lump sum is often perceived to have a greater value, and it seems like a lot more money to many people.
- It is difficult to communicate values over time. When we talk about \$3,000 of income today, in 15 years and in 30 years, it is very difficult to imagine what the differences in purchasing power might be. It is easy to ignore the fact that there will be differences.
- There is over-optimism about expected returns on investments and ability to manage investments. Note that individuals who can manage investments at retirement may not be able to do so later, particularly if they develop some type of dementia.
- There are serious misunderstandings about the relative risks of different types of investments. Many people think that a single stock, the stock of their employer, is less risky than a diversified portfolio of stocks.
- Many people are short term focused as they plan for retirement. Retirement planning often does not include serious and deliberate analysis of life and financial issues.
- When people focus on retirement planning, it is common to think about this primarily as an investment management issue. Saving and investments are very important, but only part of the picture. Professional advisors vary in their approaches, but many of them are primarily investment focused.
- There is significant misunderstanding about potential life spans and their variability. It is not uncommon to overestimate the amount that can be safely withdrawn from a retirement account. It is not uncommon to only consider average investment returns without weighing the downside risk and results if there are poor years.
- There is a lack of understanding about financial products that are useful in helping to mitigate risk and when they might be most helpful. Society of Actuaries' surveys indicate that the most commonly used risk reduction strategy is to reduce spending.



- The risks in retirement are complex and interacting. Transferable and poolable risks include increasing longevity, the cost of disability and long-term care, the cost of acute health care, economic loss on death of a spouse and investment risk and interest rate risk. Risks that can't be transferred or pooled include the inability to find a job, premature retirement risk, family members needing help and aspects of inflation risk. These are some of the key risks, and there are others as well.
- While people repeatedly say when asked that they want guaranteed income, when given a choice, they usually choose lump sums.
- For many people, there is a lot of change during retirement. Individuals go through different phases as their lives and capabilities change. However, often planning focuses on the first phase.

Family issues: The funds accumulated in a pension plan (DB or DC) are based on the work history of a single individual. However, for couples, it is common to allocate household work and work in the labor force unevenly. The pensions need to protect both spouses.

Since women live longer on average and often marry older men, they are much more likely to be the survivor after the first dies. However, in most cases the higher earner who is more likely to have a good pension or DC account is the husband.

The information about the plan and how it will impact the couple is most important for the person who lives longer. Communication about income should consider joint and survivor income and needs later in life for both members of a couple.

## **Link of Financial Literacy and Signals Regarding Income versus Lump Sums**

Individuals with a high level of financial literacy should be able to make the connection between income and lump sums without much if any help. Furthermore, they are likely to make the connection and understand the options for translation.

In contrast, individuals with a low level of financial literacy who do not understand compound interest, inflation, percentages, the time value of money and who do not focus on the longer term are likely to see the lump sum as a very large amount of money and have difficult understanding the translation.

The population today is distributed between various levels of literacy, so that there are a significant number of people for whom longer-term thinking and the translation between values are not comfortable and may be very difficult. Long term it makes sense to work on financial literacy. Short term, it is critical to accept the reality that there are large gaps in literacy.

## **What One Retirement Planner Has Suggested**

Steve Vernon, FSA has suggested an approach is to think of the 401(k) balance as a generator of a monthly paycheck rather than as a lump sum. Under this scenario, one can spend the paycheck. What you should do is to design the paycheck so that it will work considering the need to cover the rest of your life and account for inflation.

This approach to planning requires the individual to focus on expenses and how large an income or paycheck would be needed to cover them. The amount of assets needed is then the amount required to generate that paycheck.

## **What One Plan Sponsor Has Proposed**

The Ontario Expert Commission on Pensions looked at issues surrounding the DB pension system. The Ontario Pension Board in its testimony focused on leveling the playing field between DB and DC plans. As part of that general concept, it recommended mandating the illustration of monthly income for primary DC plans and mandating the provision of some life income in primary DC plans. The recommendations also focus on provision of attractively priced annuity options. See the Appendix for excerpts from their testimony. The author strongly supports the idea of communicating about monthly income. At the same time, and for the reasons stated above, when the plan does not offer any income option, this can be very tricky. The author has suggested a practical option that would reinforce the messages of income and keep actual annuity quotes up-to-date in the changing market.

## **Default Options, Inside the Plan Options and Signals**

Signals are generated by communication from the plan sponsor. They are also generated by the structure of the plan, the options it offers and what option is the default. Of course, the plan structure is also intertwined with communication and messages that are sent.

The default option in the plan is the option that will prevail if no other action is taken. Research over the last few years has served to reinforce just how important the default option is. Many employees choose the default option, and they stay in the default option. It has been found, for example, that if the plan has auto-enrollment, many more people will participate than if the default is to not participate.

Until recently, there has been little discussion of default options for payouts in DC plans. This issue is getting more attention currently. Where the default option is income, it serves to focus people on income. Where the default option is a lump sum, it tells people that it is all right to take a lump sum. Some observers believe that the default option is seen as a “recommendation” by the employer.

For U.S. private DB pension plans, the mandated default option for payouts is a joint and survivor income. A relatively recent development in the United States is the expansion of “safe harbors” for investment default options. The safe harbors also generate a set of signals about what are reasonable options. What is needed in the future is a set of safe harbors for payout defaults.

Note that default options and choice architecture are getting a lot more attention recently. *Nudge* by Richard Thaler and Cass R. Sunstein lays out these issues for general application.

## **What Employers/Plan Sponsors Can Do**

Given the realities—a complex market with many product approaches that are hard to compare, many people with low levels of financial literacy and an advisor community that does not agree on what is the best approach post retirement—this reality leaves employers with a great deal of complexity. Employers can assume a number of different roles in supporting retirement planning and financial literacy as discussed below. Each role is linked to signals and the provision of messages about life income.

- Providing retirement and capital accumulation benefits that are paid for and offered to all employees without choice. In this case, if there are DB plans, there will automatically be communication about income. If the primary plan is DC, there may be no option other than a lump sum, and then all of the complexities involved in communicating life income

described above apply. In this case, the author hopes that the employer will at least introduce the idea of regular income.

- Providing retirement and capital accumulation benefit plans that include optional methods of payout, which can be used as defaults or as options that must be affirmatively chosen. The options serve as signals with regard to what is a reasonable option. The choice of default is a very powerful signal. When there are options, the employer is obligated to offer an explanation and show the implications of different options.
- Providing retirement and capital accumulation benefits plans that limit lump sums to a part of the plan value. They can mandate that for primary plans part of the benefit be paid as a regular joint and survivor income.
- Serving as “purchasing agent”, to allow employees access to financial products such as life income or long-term care insurance on a group basis, usually with features and/or pricing more favorable than can be obtained in the individual market. Use of an IRA rollover arrangement which allows annuity purchasing is a means to allowing employees to get life income on an advantageous basis without directly putting the option in the plan. When this is done, the provision of information about life income could probably be linked to the purchasing arrangement. Providing access to life income on a favorable basis is a form of signal, as well as helping the employee achieve a better result.
- Creating expectations and providing information about how retirement is usually integrated into the life cycle. The need for regular life income and the variability of the life span should be included in efforts to build expectations.
- Advising—Employers have different views about engaging people to advise employees. The most common focus of advice is a general discussion of the assets needed for retirement investment advice. In the future, employers who are advising about investments today may also wish to provide more information about the distribution period.
- Educating—even if employers do not offer an annuity option, they can still be a primary source of education about life spans and their variability and options for achieving post-retirement security.
- Acting as a resource for information.

## **Information Needed by Employees not yet Approaching Retirement Age**

These employees need to understand how much they should be saving, their account balance and to see how they are doing with respect to reaching the goal of retirement. They should also have information that promotes the idea that retirement assets need to generate income replacement, and that they should be focused on how to get income as they retire.

Before people start saving, the critical thing is to get them to save. Once they start saving, if they are in a DC plan or an IRA, investment management and more savings are the critical issues for quite a while. However, it is still important to focus employees on the idea that the goal at the end is secure income.

Steve Vernon, FSA, in *The Quest Action Guide*, frames the financial part of retirement planning in a way that provides messages focused on income. He tells us that the goal of retirement finances is to manage I (Income<sup>1</sup>) and E (Expenses) so that I remains larger than E over our lifetimes. This is a simple conceptual message that should be embedded in early communications about retirement.

## **Information Needed by Near-Retirees**

It is the author's view that employees should receive the following messages as they are nearing the time of retirement:

- Do not forget about the need to have Income bigger than Expenses on an ongoing basis.
- Importance of having a longer-term planning horizon.
- Impact of earlier versus later retirement including effects on Social Security and pensions, how long assets are likely to last and a method to evaluate how this will affect them.
- Variability and potential length of life span—one way to show variability would be to show the average life span, and then show the expected life span for someone in very good health and someone in very poor health. You could select the 75% or 90% percentile for the very good health illustration, and the 10% or 25% for the poor health person. Labels like

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<sup>1</sup> For purposes of this discussion, think about Income as “Amount Available for Consumption on a Periodic Basis.” It may reflect income from Social Security, pensions, work, investment income or using assets gradually to finance retirement.

- good health and poor health will be much more appealing to the layperson than percentiles.
- Information on how to translate lump sum amounts into regular annual income and information about options that can be used to provide regular income.
  - For couples, information about survivor benefits and the needs of the survivor.
  - Importance of long-term care.
  - How to think about whether buying risk protection products is a good idea.
  - Basics re investing in retirement and alternatives for getting advice.

It can be argued that this list is very basic and obvious, but this is exactly the type of information that many retirees have not used effectively in thinking about retirement. The Society of Actuaries' research on post-retirement risks documents this problem. The author specifically focused on the term "used effectively" because much of this information is available and may have been given to the retirees. However, the evidence is still that they have not used it effectively.

## **A Practical Solution – What Plan Sponsors Should Do**

This leads to the author's recommendations about what employers should do. Communicating and providing signals about income is part of a larger package of communication that sets the stage for longer-term thinking, understanding the potential length and variability of the retirement period, the importance of protecting the survivor and how different approaches fit into that.

Employers should provide information on their own plans and benefits. In fact, employers are required to provide participants and beneficiaries with a summary plan description for each plan. However, even if employers and plan sponsors provide this information in accordance with ERISA's requirements, there is no guarantee that employees will read, or, in some cases, understand these documents.

In addition to information that employers and plan sponsors currently are required to provide, they should be encouraged to provide the following types of information, signals and messages to help employees manage during the post-retirement period:

- Basic information on life span, types of income alternatives and risks. Many employers will not want to create this information, and it is hoped that third party publications will be available as resources. Possible resources include the Department of Labor (DOL), Actuarial Foundation, WISER and other non-profits as well as the financial services industry.
- Strong recommendation for longer planning horizon that matches potentially increasing life spans. Many people have a much shorter planning horizon and often they rely on the employer, so this is an important message. The planning horizon is the foundation for thinking about income.
- Explanation of how lump sums can be used to generate income and the amount of income that can be generated by a specific lump sum with some examples. Recommendation that employees take a balanced approach and include communication of potential future income with communication of account balances or lump sum values.
- Strong recommendation that planning for the retirement period reflect a balance between investment management and a focus on managing risks. The DOL's Taking the Mystery Out of Retirement Planning is a good start in that direction.
- Questions to ask and information to help people think about decisions and alternatives. Many of the decisions involve trade-offs and are not easy.
- General information about products that can be used to enhance personal risk management, and tips about buying them.

## **What Might Be a Practical Solution to Illustrating Income**

Tailor communications to life stage:

- Before employees get near retirement, remind them that income replacement is the goal and that they need to focus on how to make retirement resources generate income that is greater than expenses. Provide some basic information that helps employees to think about the magnitude of income and give them access to translation resources.
- As employees near retirement, a lot more is needed that will help employees focus on how to convert assets into income, and what the options are.

A critical message is that it is important to translate a lump sum into income and think about the lump sum as the path to a regular income. A message that

might work well would be to provide the following information on benefit statements:

#### Plan with no income options—ongoing communication

The basic goal in financial planning for retirement is to keep income greater than expenses for the rest of your (and your spouse's) life. Your account balance can be used to provide regular income. If you wish to preserve principal and live off investment earnings averaged over time, many planners recommend that you can safely withdraw 4% of your account balance each year. Based on your current account balance, the amount of initial monthly income that it would provide is \$\_\_\_\_\_ per month, starting on \_\_\_\_\_.

If you wish to use the principal over your lifetime, you can purchase an annuity with payments guaranteed for your life and that of your spouse, and no return of principal after the second death. (Provide an example as part of the communication). (The amount of a life income will be considerably larger than a payment of investment income only because the assets of those who die are redistributed to the survivors, but no payment would be made to your heirs.) You can also arrange an installment payout that is based on payment over a longer period—based on average life expectancies, but with full return of unpaid principal on your death. There are trade-offs between these options and differences in the amount of income available. The income amount will change regularly with changes in the market.

In order to find out how much income could be provided for a given account balance and ages, an employee can go to a Web site provided with endorsement from the employer or provided by the employer. The communication would encourage the use of the Web site. If the plan sponsor does not offer a Web site, it might encourage using a Web site such as Fidelity's to get examples of what annuities can provide. If the plan sponsor offers annuity purchase through an IRA rollover program, it would likely link the quotation to the IRA rollover program.

#### Plans with direct income options—ongoing communication

The author suggests that these plans might want to include an example life and survivor income estimate as well as the monthly income above together with a Web-based tool to look at other options.



### As employees near retirement age

The author suggests that annual or regular statements be supplemented with a retirement planning statement focused on how much income can be provided at different retirement ages, and what some of the options are.

### An alternative approach

An alternative approach would be to show what lump sum would be needed at different ages to approximate different levels of income. For example, a table may be constructed showing that a lump sum of two, five or 10 times final pay will produce an approximate income replacement percentage at several different retirement ages. This could be shown with no increase for inflation and with an estimated increase.

Another alternative is to encourage the employee to figure out a budget for what they need in retirement, deduct the income they have in Social Security and DB plans, and then use this amount to determine what lump sum is needed to fill the gap. Software would be needed to help most people calculate the needed lump sum.

## **Conclusion**

It is important to focus on pension resources as the path to income in retirement. The plan, the information communicated to the participants and supporting resources all provide signals that can focus the participant toward or away from regular income.

## **Postscript**

In addition to providing signals through plan structure and education, there are other steps that employers can and should take. They are beyond the topic of this paper but should not be forgotten. They include the following:

- Recognize that education is good but has its limits, so that program structure is key. The program structure ideally will respond to the limitations of retirement literacy. Support education by offering it on company time.
- Focus on default options for the distribution phase. There has been a great deal of discussion about default options for investment and auto-

enrollment. Much more discussion is needed about distribution options, particularly default options in DC plans.

- Facilitate group purchasing of financial products for voluntary purchase to enable employees to get a better deal and be assured that the design and provider of the product has been subject to due diligence. If an employer does not want to offer group purchase of annuities directly, it can work with a third party and use of an IRA to hold funds until the annuity is purchased.
- Limit how much of the plan benefit can be paid as a lump sum.

## Appendix

Excerpts from the Submission of the Ontario Pension Board to the Ontario Expert  
Commission on Pensions  
November 1, 2007

### ***RECOMMENDATION 4: Level the Regulatory Playing Field for DB and DC Plans***

We think that simply addressing changes to the DB model, while necessary, will not be sufficient to encourage coverage. The irrational features of the current regulatory system which favour DC plans or no plans at all need to be addressed as well.

### ***RECOMMENDATION 4A: Require DC Plans to Measure and Report to Members***

#### ***Expected Retirement Income Levels and the Adequacy of their DC Assets***

**RECOMMENDATION 4A:** The PBA should be amended to require DC plans to set and disclose to members target lifetime retirement income levels and to monitor and report on the adequacy of assets in the account to fund that level of income so that participants can see what life income is likely to be produced by the account; how it may vary based on various factors including investment returns, expected longevity, inflation and whether the assets are sufficient to fund various levels of benefits. This should apply only if the DC plan is the primary plan provided by an employer. The point here is that primary plans should be focused on retirement and therefore should report to the member on asset/liability management, not solely on asset accumulation. It is recognized that implementing this recommendation may be challenging but the mechanism developed need not be cumbersome.

**Background:** The regulations to which DB pension plans are subject are designed to regularly monitor and disclose the adequacy of the assets in the plan to deliver on the pension promise. DB plans are established with a view to delivering a target retirement income over the life of the member and the member's spouse. Where the measures applied to DB plans indicate that the assets fall short of the liability for the promised benefit, the regulations force remedial actions to be taken to bring the assets and the liability back into balance. This is all as it should be.

DC plans are not subject to such regulation. They are not required to set and disclose the level of retirement income that might be expected to be generated based on the contributions to the plan and reasonable return and demographic assumptions. There is no ongoing measurement or reporting of

whether the assets in the individual's account should be adequate to deliver that expected level of income or what level of income they might reasonably be expected to deliver. There is no remedial action mandated if there is an indication that the assets will not be adequate. In short, they are regulated as savings plans not as pension plans. The primary piece of information that is delivered to members is the lump sum value accrued in the account. These lump sums can seem large to the ordinary person with no information to help in understanding the size of the pool of capital required to generate a desired level of lifetime income and to address investment, morbidity, longevity and inflation risk. This can contribute to a view of retirement readiness that is out of line with reality. As such, it fails to properly protect members. The differential regulatory burden between the two types of plans is not justified in terms of the need for protection of plan members and it contributes to employer's relative dissatisfaction with the DB model.

***RECOMMENDATION 4B: The PBA Should be Amended to Require Some Level of Mandatory Annuitization in Primary Employer-Sponsored DC Plans***

**RECOMMENDATION 4B:** The PBA should be amended to require some level of mandatory annuitization in employer-sponsored DC plans. This would apply only to DC plans that are the primary plan provided by an employer. The Government should develop an approach to enable the development of a large annuitant pool and a not-for-profit/low cost annuity provider(s).

**Background:** Longevity is a big risk at an individual level as is investment risk during retirement. It is very expensive to lay off those risks as an individual. These risks are poorly understood by most people. Most concentrate on the possibility of early death and buy life insurance but don't contemplate the possibility of living well into their 90s and the implications of that. Therefore they don't feel a burning need for protection against longevity. The reality is that increasing longevity is one of the reasons for the increased DB plan liabilities that are leading employers to want to lay off pension plan risk. That should tell us that individuals need to be equally, if not more, concerned.

This implies pooling of investment, disability and longevity risks. The DB model offers such pooling of risks and the DC model does not. One of the challenges of providing life income to members of DC plans is the cost of annuities purchased on the open market.

There should be a method of providing life income that enables the guarantor of the income to have a reasonable risk pool, and it should be managed efficiently so that expenses can be kept low.

Research shows that even for those with significant net worth, the optimal approach is to annuitize a significant portion of their assets but that most people still do not annuitize.<sup>35</sup>

This implies that at least part of the benefit should be paid as a life annuity with continued benefits to the survivor. The legal annuity mandate may be set to provide, together with government benefits, a minimum reasonable level of income. Above that, it may be that plan sponsors should be able to choose what they want to set in the way of mandated income.

*Notes with regard to excerpts—there is additional background on recommendation 4B with regard to the annuity provider.*

*The PBA is the Pension Benefits Act—major pension legislation in Ontario.*

*The full submission is available on the Web site of the Commission:  
<http://www.pensionreview.on.ca/english/submissions/>*