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INTERESTING PERSPECTIVES ON LIFETIME INCOME

Compiled by Anna Rappaport with assistance from Steve Vernon, Chuck Yanikowski, Ron Gebhardsbauer, and Steve Utkus

In September 2013, the Society of Actuaries released a new Committee on Post Retirement Needs and Risks research report "The Next Evolution in Defined Contribution Retirement Plan Design – a Guide for Plan Sponsors to Implementing Retirement Income Programs." The report is authored by Steve Vernon, and the Society of Actuaries partnered with the Stanford Longevity Center on this project. The report is intended to help plan sponsor fiduciaries understand existing options for retirement income solutions for DC retirement plans. The report provides a rationale for plan sponsors about why such programs are important and includes a roadmap to assist the sponsor in the assessment of their workers' needs and in the design and implementation of a plan that meets those needs in a profit-neutral or profit-advantageous way. The report includes stochastic analyses by Dr. Wade Pfau and a discussion of fiduciaries by representatives of law firm Drinker Biddle & Reath. Also available is a PowerPoint Presentation that summarizes the research, for use by those interested in presenting the material.

The report advocates for retirement income solutions, but within the retirement community there are a range of opinions on when annuitization is desirable, and how much money should be annuitized. The Committee on Post-Retirement Needs and Risks maintains a listserve with many retirement experts participating. When the report was released, there was a discussion of interesting issues surrounding annuitization. This article shares some of that discussion.

Chuck Yanikoski challenges the wisdom of using retirement assets for a defined program of paycheck replacement, while Steve Vernon advocates for it. Additional comments from Ron Gebhardtsbauer also advocate for a programmed stream of retirement income. Steve Utkus provides insight on the prevalence of defined benefit plan income among people retired today, and cautions us not to expect too much annuitization too soon. I have selected excerpts from the conversation and have given the participants a chance to edit what they said. I have also added some personal comments. I encourage all of the readers to use the Pension Section's LinkedIn group to sustain this conversation.

The Discussants:

Ron Gebhartsbauer is a fellow of the Society of Actuaries and the leader of the actuarial program at Penn State. He was previously the senior pension fellow for the American Academy of Actuaries, and served in several governmental and consulting roles.

Steve Utkus oversees the Vanguard Center for Retirement Research, which studies many aspects of retirement in America—from how individuals start saving and investing in the early part of their careers, to how they prepare for actual retirement, to how they spend down their savings once they're retired. Steve is also a visiting scholar at the Wharton School, where he earned his MBA.

Steve Vernon is a fellow of the Society of Actuaries, a writer for CBS Money Watch and a research scholar at the Stanford Longevity Center. For many years he consulted to plan sponsors about their retirement programs.

Chuck Yanikoski is the president of Still River Retirement Planning Software, Inc. He has been an active participant in the work of the Committee on Post-Retirement Needs and Risks. He is a chartered life underwriter and spent 18 years at New England Life before entering the software business.

Anna Rappaport is president of Anna Rappaport Consulting and chairs the Society of Actuaries Committee on Post-Retirement Needs and Risks. Anna is a fellow and past president of the Society of Actuaries.

Chuck Yanikoski: This is an expertly done report on a subject that represents the current direction of the industry, which unfortunately is to help take retirees over a cliff.

There continues to be an assumption that some kind of essentially level (or smoothly inflating) income strategy is what people need. Some people do, but not many. Given the life expectancies documented in this report, and the literally dozens of contingencies (or in some cases, virtual certainties) that can arise over such spans of time, I think we have to assume that for most people, the likelihood of a smooth income need for life has close to zero probability of being appropriate. Therefore institutionalizing such income patterns is actually harmful to a majority of retirees. Those with smooth withdrawal patterns who will actually need more later will not have it when they need it, while those who need less later (say, because a mortgage will be paid off in 10 years) will be cash-poor in the early retirement years when, probably still having health and leisure, they could benefit most from having more money available to them.

The only thing that makes strategies like these less than totally catastrophic is that many people have additional assets of some kind, so they have some latitude to mitigate the dangerous implications of the proposed options. But many middle income families, and most lower income families, do not have such resources, so the people that are hurt the most are the ones who can least afford to be hurt.

If retirement income really is a fiduciary responsibility, I could easily make the case that adopting any of the strategies in this paper would be a blatant failure on the plan sponsor's part to meet that responsibility. I might not win the case, but I think I would. Unless there is a better answer than any of these, I personally would advise plan sponsors to stay out of it altogether.

Social Security and traditional pensions are everybody's favorite retirement resources because they are perceived as free, or mostly free. Even Social Security is only half paid for by the employee, and for most current retirees will end up being subsidized by the taxpayers as well.

Steve Vernon: Hi Chuck,

I appreciate hearing different points of view. You and I happen to disagree on this point. I will briefly present the case for the point of view expressed in the paper.

While most people are working, they receive a somewhat level form of income through a monthly paycheck. This imposes a powerful financial discipline on most people -- they can't spend much more than their paycheck. Yes, there are lumpy expenses such as insurance, property taxes, and unexpected repairs/medical bills. Yes, the income might be lumpy through bonuses, layoffs, job changes, and other interruptions or additions to monthly income. Workers are accustomed to managing these lumpy income and expense amounts, through loans, credit cards, insurance, liquid emergency funds and budgeting for non-regular expenses.

Most people adhere to some form of regular budget, either on paper or in their head, they know how much they can spend each month. There may be some leeway, but someone who makes $5,000 per month knows they can't spend $10,000 per month indefinitely.

The idea of a regular retirement paycheck is to duplicate the fiscal discipline that most workers have used throughout their working career. When people retire with a lump sum and have no strategy to systematically draw down their retirement savings, most people don't have the financial know-how to make that money last for life, and for many there's a tremendous temptation to spend the lump sum too fast.

Setting up a regular retirement paycheck imposes a financial discipline to make sure your savings last for life, and the paper shows various methods for doing this, with different attributes (lifetime guarantees or not, increasing or decreasing pattern of income, exposure to stock market risk, etc).

If you follow the paycheck strategy, when you're retired, you still need strategies to deal with lumpy and unexpected expenses, and having an emergency fund, line of credit/credit card, and insurance are three ways to do this - similar to when you're working.

There are studies that show that people of the prior retired generation who had significant defined benefit pensions have fared much better in retirement than people without pensions, and they are happier. This result is in an environment with unexpected expenses, medical bills, long-term care bills, etc. The experience of the prior retired generation provides support for our point of view. Our goal is to duplicate a "pension" within a DC plan.

I happen to believe that having a retirement paycheck strategy in place significantly decreases the chances of the majority of retirees "going over a cliff" and of "catastrophic failure."

Thanks again for expressing your opinion. Debating the issues is always healthy.

Ron Gebhardtsbauer: I totally agree with Steve on this point of a "level" income or purchasing power being preferable. When I testified before Congress on this issue, I surveyed retirees on their favorite retirement assets. (***Note: Ron testified before Congress often in his role as senior pension fellow at the American Academy of Actuaries.***)

(1) Invariably, they ranked Social Security higher than their other income, even when their Social Security Benefit was smaller, because they really liked that it always went up with inflation (never down).

(2) Next they liked their flat pension or their variable TIAA-CREF annuity. Often they liked the flat pension better than the variable annuity, because they knew it wouldn't be going down. Maybe it depended on when I was asking (which impacted whether the variable annuity was going up or down). My initial experience on Variable Annuities was in the late 1970s when the benefit went down while inflation was going way up.

(3) Many people never even ranked their other assets, because they were afraid of touching them.

(4) I reminded them that they forgot to mention their home, at which point they would rank that, but often they would still not put their assets on the ranking list.

This depends on whether they had enough income to easily cover all their expenses (i.e., were they really rich and could self-insure?), but I didn't know any fabulously rich people.

Anna Rappaport: Recent focus groups conducted for the Society of Actuaries indicated that average American retirees are very focused on managing their expenses to fit their income, and that their planning is linked to regular income.

Chuck Yanikoski: Thanks, Steve, for your sensible comments, though I am afraid we will continue to (mostly) disagree on this.

Working people have a lot more flexibility than retired people, and when serious "lumpiness" occurs they often go get a second job, they borrow from their parents (or move in with them), they borrow from their retirement plan, sometimes they even get married (or divorced). Generally speaking, these options are not open to retirees, especially older ones. Retirees need to plan more carefully, or just accept the increased likelihood of a bad outcome.

My understanding of the data is that most people who retire with access to a significant sum of DC money do NOT spend it recklessly, and it is more common for them not to touch it at all. They know it won't last forever if they spend it. The problem is that they don't know how much is appropriate for them to spend in any given year. So whether they spend a lot, a little, or none, it is probably not the best amount.

Putting people on a smooth withdrawal strategy helps this situation only a little. It gives them a number that is, or at least intends to be, somewhere between way too much and way too little. But the odds of it being close to the optimal number are still very poor if it is simply based on estimates of how long the money needs to last.

Anyway, the problem is not "lumpiness" so much as permanent changes. In our parents' day, most people with mortgages had them paid off by the time they retired. Today, most long-time homeowners have refinanced several times, and often have extended the terms of their mortgages, so that now it is very common for people to retire with mortgages. At the time they retire, they know their expenses are going to go way down when that mortgage is paid off. How can it make sense not to take that into account? So maybe you add that to the model, but there are a lot of other things. If one spouse is older or sicker, and there is a strong probability of that spouse dying sooner, then normally, a whole lot of things change when that event occurs, and the survivor could be a whole lot worse off, or a whole lot better off financially, depending on the details. How can it make sense not to take that into account? Or a plan to sell one's house or otherwise relocate in, say, ten years, which will totally change one's living expenses? Or an inheritance that one has a legitimate expectation of receiving? Or some other benefit, or expense, or other change that can be anticipated? Or items that are merely probable (like reductions in most expenses in true old age)?

I guess affluent people have other means to deal with these things, and for them I don't really object to the strategies you discuss. But a lot of retirees always have been, and in our generation tens of millions still will be, living pretty close to the edge. They cannot afford to have their money managed according to a mathematical scheme that merely produces the neatest possible trend line. They need one that is as smart as possible.

I do not mean to say that annuitization, or other simple schemes, never make sense. They often do, but almost never as the total answer. Retirees FIRST need a better way to understand what their cash needs are likely to be over the long haul, and only then can they decide (preferably with help) what's the best way to meet those needs, as well as whatever contingencies they can afford to deal with.

I see no excuse for making a smooth withdrawal plan the normal default, or even the normal recommendation. It's just taking the lazy way out, and people expect more of someone with a fiduciary responsibility.

Steve Vernon: Hi Chuck,

Here's some clarification on our goals for this paper and future research efforts.

Let's start with a quote from a prominent behavioral scientist.

"For many people, being asked to solve their own retirement savings problems is like being asked to build their own cars." — Richard Thaler, "Shifting Our Retirement Savings Into Automatic," *New York Times*, April 6, 2013

Given your comments below, it seems we don't disagree very much.

We don't advocate that people ignore all the life events that you mention below, such as paying off the mortgage, health of a spouse, planning for survivors, relocating, and so on. These are all events that ideally someone should consider when planning for retirement.

We don't advocate that people devote all their retirement savings to a retirement income generator. In fact the paper advocates that plan sponsors give participants flexibility in this regard, allowing for a portion of savings to be paid as a lump sum and another portion devoted to generating a paycheck. You could have good reasons to receive a partial lump sum payment, such as paying off a mortgage or retiring other debt, or holding an emergency reserve.

We are just advocating that plan sponsors provide participants with tools to help secure reliable retirement income, so participants can take this into account in their overall planning. Plan sponsors can also deliver significant advantages to their participants with institutional pricing of retirement income solutions instead of retail pricing.

If a participant works with a financial advisor (a common possibility acknowledged in the paper), ideally the advisor would take into account all the events that you mention when developing a retirement plan for an individual. Such a plan might take advantage of the institutional pricing of retirement income options for the savings that are devoted to generating a retirement paycheck.

We are just advocating that plan sponsors offer tools to plan participants that they (and their advisors) can use to plan a secure retirement.

Thanks for listening.

Chuck Yanikoski: I can accept this, if plan sponsors are made to understand that some kind of preliminary analysis along these lines is an essential element of providing retirement income, and perhaps even that, as with reverse mortgages, a suitability analysis has to be performed before any retirement income arrangement goes through. Plan sponsors wouldn't have to be responsible for doing the analysis, but it would be a requirement before any retirement income option were actually implemented. Otherwise it would be like a doctor giving you medicine before doing a diagnosis—which is a pretty close analogue to what happens in a lot of retirement income planning today.

Steve Utkus: As Anna reminds us from time to time (most recently at Wharton's Pension Research Council), households with substantial financial assets are not the norm. Steve Vernon's analysis focuses on households with $250k-$1million in any type of saving (taxable, tax-deferred), representing about 20 percent of older households today. There's probably another 5 percent who are > $1 million. (This data is from Poterba, Venti, Wise, Composition and Drawdown of Wealth in Retirement, Table 2).

However, if you drop down to $100k or more in financial assets, that represents about 40 percent of older households. So that group is already 4/10, and it is expected to grow.

That said, we know that financial assets and DB plans overlap in the top half of the wealth distribution. So, from some work we are doing at Vanguard, among older households with more than $100k in any savings or investments, more than 70 percent have some DB income. That includes military, federal, state and local, plus private.

The conclusion I draw from this data is that the shift toward lifetime income strategies will be slow. Lots of older households with sizeable financial assets don't need much help because of the "long tail" of corporate DB income.

This is one reason here at Vanguard we hypothesize that you see very limited drawdown from IRAs & K plans in the 60-70 age range—at least today. Many don't draw down unless they have to (starting at age 70.5, the Required Minimum Distribution age).

Still, there is this small but growing group who needs retirement income help.

Anna Rappaport: Thank you all for a very interesting and thought provoking discussion. Some key points from my perspective are:

Planning is essential, and the plan sponsor has a real opportunity to offer tools or support to help their workers

Everyone needs a post-retirement plan

All or nothing solutions are not a good idea

Employers can provide a very important service to employees if they help them understand the range of possibilities and give them a framework for evaluating them

Employers can offer an additional important service by providing access to products using institutional pricing and competitive bidding.

We should also remember that past draw down of financial assets is not likely to be a reliable indicator of what will happen in the future. Earlier studies tended to find that older, wealthier families often had DB benefits, and did not develop an added income plan. Wealthier families also commonly continued to grow their assets during retirement. As new cohorts of retirees have less DB income, building an income plan from invested assets will become much more important. ■