Retirement Security in the New Economy: Developing New Paradigms for the Payout Period

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Abstract

As we focus on the organization of the retirement security 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 (DB) plans, this was not seen as 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 postretirement period through annuitization or other options has become much more important. The economic conditions in 2008-2009 serve to emphasize the importance of focus on the payout period. However, although many people say monthly income is important to them, few people choose monthly income when given a choice of a lump sum, and that has not changed.

This paper will look at the perspectives of several different stakeholder groups: policy makers, plan sponsors, and participants. It will consider:

- how messages create signals and influence behavior
- how reliance on past retirement models reduces favorable outcomes for the future
- how decisions are needed at different times and how they are inter-related
- how plan structure and options influence outcomes, and
- how markets fit in
- how working longer impacts both preretirement and postretirement decision making

Choices are very important and wherever there are choices, defaults are important. While extensive work has been done on defaults for auto-enrollment and investments, much more work is needed on the payout period. This is an issue that cuts across many countries.

As we think about retirement, we should remember that for many people, there are several phases of retirement:

- An initial active period, which may include some work, and which includes a variety of forms of engagement
- A more limited period, where physical or mental limitations impose some restrictions on the individual
- A severely limited period, when a lot of care and support are needed

As we think about payouts, it is important to remember that needs vary during these periods. Earnings to supplement retirement income are most likely in the first period. Extra spending to meet dreams is most likely in the first period. Added costs for care are most likely in the last period. Individuals choosing special housing that includes support will find significant extra costs for such housing.

This paper builds on work done previously by Anna Rappaport for Retirement 20/20—papers on default options in defined contribution (DC) plans and signals and the form of retirement income, on testimony given to the ERISA Advisory Council by Anna Rappaport in 2008 and 2009, on papers from the OECD that help us understand why this is a global issue, and on work on holistic planning and decision making. It will cite some research from the Society of Actuaries (SOA) and other sources. It reflects the opinions of the author and does not represent the opinion of any organization.

Introduction

To structure a successful retirement security system for the future, an important aspect to consider is the payout period and achieving sustained income after retirement. During the time when many Americans were covered by traditional defined benefit plans, this was seen as not a major concern, 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 income management during the postretirement period through annuitization or other options has become much more important. Although many individuals will say regular monthly income is a priority for them when asked, few choose to take a monthly income option when also given a choice of a lump sum. Because individual situations vary, availability of choices can be beneficial in a retirement income context. Yet, wherever there are choices, it is also important to structure defaults within the menu of options that will protect those who are passive or not well-informed.

Besides the impact of choices and defaults on the payout period, another factor to consider is that many retirees experience several, distinct phases in retirement including:

- An initial active period, which may include some work, and a variety of forms of other engagements, such as travel and vigorous recreation
- A more limited period, where physical or mental limitations impose some restrictions on the individual
- A severely limited period, when a great deal of care and support are needed[1]

As shown by SOA research, how income is expended and the amount of income needed can vary greatly during these periods. Earnings to supplement retirement income are most likely in the first period described above. Extra spending to pursue lifelong dreams and other activities is also most likely in the first period, while, on the other hand, additional expenditures for health and personal care needs are most likely to occur in the last period. In addition, individuals choosing special housing that provides support for health needs will encounter significant extra expenses for such housing.

Topics to be covered in this paper include:

- Personal decisions related to the payout period
- Current perspectives on the payout period
- Stakeholder issues
- Primary forms of benefit payment
- Current distribution practices in the U.S. retirement system
- International practice
- The impact of choices, timing and literacy in the retirement decision process
- Risks in retirement
- Investment decisions by individuals who retired with DC account balances

[1] The phases of retirement are developed in more detail in the Society of Actuaries 2007 Report, 2007 Risks and Process of Retirement Survey; Key Findings and Issues – Phases of Retirement.

- Taking action today
- Longer-term strategies

The opinions expressed in this paper are solely those of the author.

Personal Decisions Related to the Payout Period

The individual is faced with managing a pool of resources accumulated before retirement over a long period of time, an entirely different process than the financial management required preretirement where there are regular earnings. Social Security provides some regular income replacing a part of preretirement earnings and traditional defined benefits (DB) plans do the same. However, defined contribution (DC) plans and some DB plans offer a lump sum and the individual is faced with deciding whether to self-manage a pool of money to be spent gradually, buy an annuity or other financial product, or do some combination of these things. The individual must also decide whether to hire an advisor and how much authority to delegate to the advisor. The nature and magnitude of the financial challenges are totally different from those earlier in life. Some of the questions to be asked are outlined below.

As the individual thinks about retirement resources during the period 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[2] of employees include:

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

Dealing with these concerns often seems confusing, and the decisions are complex. For retirement resources in excess of Social Security and DB income, there are choices and a variety of trade-offs:

- Guaranteed lifetime income can be secured in exchange for giving up liquidity, control of assets and potential to leave money to heirs
- Costs for annuities are often viewed as high
- Variable lifetime income through purchase of a variable annuity has lower cost and higher potential income than a fixed annuity, but with greater investment risk borne by the individual
- 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 had big declines and are risky
- Inflation protection can be included in annuities but at the price of a significant reduction in initial monthly income.
- Bond ladders and structured investments preserve control and liquidity but without lifetime guarantees or transfer of investment risk.

[2] Concerns are developed based on informal conversations with sponsors of defined contribution retirement plans.

It should be noted that it is possible to choose structured investments or guaranteed lifetime income for a part of the portfolio, and to make additional annuity purchases later. Some strategies are irrevocable once implemented, whereas others can be changed later. See Exhibit VI in the Appendix for more detail on the options and which can be changed later. The Appendix also includes a discussion of postretirement risk.

The size of the asset pool determines which options are practical. The considerations in the choice of retirement income versus 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 a barrier to purchase. It leads to the need to think about how much of the portfolio might be used to buy annuity income. The author's opinion is that the entire portfolio should not be annuitized.

The period after labor force exit will be quite long for some people who may live to age 100 or beyond. Success during the retirement period requires a combination of financial management including a focus on risk, health management, focus on relationships, focus on engagement, and activities that are meaningful to the individual.

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."[3]

The way 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
- Decisions made by peers
- Taxes and ability to keep funds on a tax deferred 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

[3] Richard Thaler and Cass Sunstein, "Nudge: Improving Decisions About Health, Wealth, and Happiness".

Current Perspectives on the Payout Period

Recent events have reinforced just how varied are the perspectives on the payout period and what retirement plans should do to address its challenges. Retirement 20/20 is the Society of Actuaries effort to look at the future of retirement systems. During 2010, papers were presented as part of Retirement 20/20 offering ideas for the retirement system of the future. They were "rich in ideas" and covered many topics. The ideas overlapped and varied, and in total they should offer a valuable resource for the future. Most of the papers focused on an organized and systematic way of using the accumulated retirement resources to provide retirement income. Some of the variations in managing retirement income included:

- Mandating or not mandating an annuity payout
- Inclusion of indexing for inflation in the annuity payout
- Varying the payout with investment experience
- Sharing the risk that population mortality improves over the entire population by using pools linked to cohorts
- Using Treasury Inflation-Protected Securities (TIPS) as an investment to offer inflation protection with minimal risk
- Using longevity insurance that starts payments at a high age

The majority of the authors are very supportive of organized systems of annuity payment. Many actuaries and economists who are not in this author pool also favor systematic payouts. My conclusion is that there is a major group of experts who favor systematic and guaranteed payment of income benefits. But others have very different ideas.

In June, 2010, just two weeks after Retirement 20/20, The Conference Board sponsored a Retirement Roundtable, offering a chance for retirement benefit plan sponsors to get together to share concerns and priorities. I had the privilege of serving as co-chair of the Roundtable, and working to get input from participants about their major concerns surrounding retirement plans today. The participating employers were mostly from larger organizations in a range of industries. As the world has shifted to more and more DC, lump sums are the common method of payout. Methods of handling the payout period was not high on the priority list of the plan sponsors, and it seems that an increasing number of plan sponsors take the view that it is "not my problem." We need to remember that many people have multiple jobs during their careers, and in these cases, this particularly makes sense. It seemed to me that there is a totally different perspective about the payout period from two groups: plan sponsors are viewing this as an individual responsibility, and experts thinking about the future of the retirement system are concerned about how to build in well structured payouts. Other experts, who focus on multiple jobs and the payout period, have various solutions. One set of solutions involves portable plans so that the benefits move into a single plan. A different set of solutions focuses on the use of advisors to help in structuring use of assets from different sources.

We can get more insight into this topic if we look at the responses to the Request for Information sent out by the U.S. Department of Labor and the Treasury Department and the hearing that followed in September 2010. A long list of questions about the payout period received more than 700 responses, which are available online for those who wish to study them.

In reviewing a few of the responses, it seems clear that there is a great deal of diversity of opinion as well as opposition to any mandates. It seems extremely unlikely that annuity payouts will be mandated from DC plans.

Some Observations and Comments About the Responses to the DOL and the Treasury

There is a large difference in perspectives among the respondents. However, it is clear that there is virtually no support for mandating annuity payouts from DC plans. There is no support in the business community for mandating that an option providing for annuity payouts be made available or for requiring that income amounts be illustrated on statements. There seems to be little interest in making income defaults available.

There is more interest in enhanced education about payout period options and strategies, and it has been suggested that the DOL might offer an income calculator on its website.

The ERISA Industry Committee testimony made clear part of the reason business is not more supportive on annuity options inside plans*:*

> *"Under most private sector major-employer sponsored DC plans, the default form of distribution is a lump sum, and the overwhelming majority of DC plans do not offer installments or annuities as a distribution option. And, with respect to DC plans that provide other forms of distribution, ERIC members report that nearly all participants take the lump-sum option. Likewise, ERIC members report that 80% to 90% of the employees who have a lump-sum option under a DB plan elect to take their benefits in a lump sum."* [4]

Where participants have had access to in-plan income options and a choice of a lump sum, few have chosen the income. The testimony of the Profit Sharing Council of America reinforced these messages.

Added insights are offered by the testimony of the Profit Sharing Council of America:[5]

> "*The looming retirement of the baby boom generation has resulted in an increased focus on the 401(k) "retirement distribution phase" by those in the employer-provided retirement plan community. At the same time, retirement plan participants continue to take their retirement distributions in lump sum form. Less than 1 percent of defined contribution plan participants select an annuity distribution option when one is offered. Defined benefit pension plans are experiencing a similar lack of participant interest. For the one-half of defined benefit plans that offer a lump sum payment, more than 90 percent of participants endure the cumbersome spousal waiver procedures to avoid the otherwise required annuity distribution.*
>
> *"A major factor in the limited usage of annuities in retirement plans is that average wage workers already are provided with a substantial annuity when they*

[4] ERISA Industry Committee Testimony at September 14, 2010 DOL/Treasury Hearing on Lifetime Income
[5] Profit Sharing Council of America Testimony at September 14, 2010 DOL/Treasury Hearing on Lifetime Income

retire. According to the 2010 Social Security Trustees Report, the average 65 year old retiring in 2010 will receive an inflation indexed Social Security benefit that replaces 40.8 percent of pre-retirement income. Married couples can each elect to receive their own benefit or 150 percent of one spouse's benefit. Social Security provides a 100 percent survivor's benefit. In two-earner families, the surviving spouse can switch from their own benefit to the spousal benefit if it is higher. If an average retiree seeks to replace 80 percent of their working income in retirement, Social Security will provide half that amount, indexed for inflation.

"In general, because participant interest is so low, defined contribution plan sponsors increasingly see no reason to accept the additional fiduciary exposure that comes with an in-plan annuity option. As a result, the availability of annuity options in employer sponsored defined contribution plans has been declining. In the Profit Sharing/401k Council of America's survey of 2009 plan year experience, 19 percent of plans offered an annuity distribution option. This is down from 23 percent in 2005 and 34 percent in 2000."

Later on the testimony points out:

"A significant portion of the industry is marketing their annuities on an IRA platform like that provided by the Hueler Companies Income Solutions® platform rather than as a direct plan distribution option. The market is delivering solutions to the concerns about fees and flexibility."

These platforms offer flexibility with regard to the timing of annuity purchase, partial purchase, form of annuity, and they can offer institutional pricing. Some information from the Hueler Companies statement is provided below. The Profit Sharing Council of America testimony also discusses the needs of participants:

"Individual retirement situations vary widely and participants need the flexibility to tailor solutions to fit their individual needs. They need:

- *Access to a broad range of annuitization options.*
- *The ability to annuitize only a portion of their retirement assets.*
- *Access to multiple providers so they can diversify their investment risk.*
- *The ability to make multiple annuity purchases over time.*
- *Access to annuities with inflation protection."*

In contrast, others such as the American Academy of Actuaries are very supportive of lifetime income and focused on longevity risk. The Academy said in its testimony:

"*We support the Agencies' efforts to facilitate access to, and use of, lifetime income arrangements. From an actuarial perspective, we recognize that lifetime income arrangements protect against longevity risk, the risk of people outliving their financial resources. Lifetime income arrangements are also economically efficient, since it is significantly less expensive to pool longevity risk through a* *lifetime income arrangement than to 'self-insure' the risk by accumulating assets adequate to last until a very old age. Lifetime income arrangements also provide other benefits: they provide retirees with a budgeting signal to help protect against overspending; they help retirees avoid unnecessarily underspending out of fear of outliving their resources; and they reduce senior citizens' money management responsibilities at advanced ages, when they might be significantly less able to manage investments and finances.*

"A multi-pronged effort would be most effective in expanding access to and use of lifetime income arrangements, including: improving financial literacy; incorporating behavioral finance ideas in disclosures and plan design; utilizing diverse types of lifetime income options to address participant concerns and individual circumstances; and requiring that a guaranteed lifetime income option be offered in tax-qualified plans."[6]

Employers can offer institutionally priced annuities to their employees who are retiring with DC balances through a rollover arrangement, such as the one offered by Income Solutions. The statement submitted by Income Solutions stated:[7]

"We believe that giving participants access to institutionally delivered alternatives for converting retirement savings into lifetime income is vital. Providing participants a cost effective means to "pensionize" their hard-earned savings into a "paycheck for life" is necessary in order to meaningfully improve income sufficiency for millions of American retirees. Without such capabilities being widely accessible to defined contribution plans, the defined contribution system has severe limits in terms of serving the public interest and meeting the retirement needs of an aging population. The defined contribution system has evolved substantially and now serves as the backbone for retirement savings for millions of working Americans. To ensure the system continues to evolve for the good of all workers and retirees, it is necessary to build the third leg of the stool."

The Hueler statement provided insight about the development and acceptance of its program:

"*In 2000, Hueler Companies pioneered the development of a web-based platform that facilitates efficient, transparent, low cost delivery of lifetime income annuity options to transitioning employees. The broader mission of this effort was to create a platform that transformed annuity delivery to plan participants by applying an institutional framework, eliminating the inherent conflicts of interest, and allowing for open affordable access to all plan sponsors. After several years of research and development directly with plan sponsors and annuity providers, Hueler*

6 American Academy of Actuaries Testimony at September 14, 2010 DOL/Treasury Hearing on Lifetime Income

7 Hueler Companies statement submitted on May 2, 2010 in response to DOL/Treasury Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans

launched the Income Solutions® annuity program in 2004. In July of 2005, Hueler provided testimony before the ERISA Advisory Council Working Group on Retirement Plan Distribution Options.

"To date over 1,000 plans have adopted the Income Solutions® program in order to extend access to lifetime income alternatives to their participants nearing, at, or in retirement. It is important to note that, while the program was designed to facilitate implementation as either an in-plan option or a voluntary IRA rollover, 98% of plans choose the voluntary IRA rollover distribution alternative."

This program is primarily used as a rollover program. The Hueler statement points out that the program can be used through the plan administrator and that three of the top six plan administrators, and six of the top 17 plan administration firms, are now using the program, so that it offers access to millions of participants in thousands of plans.

Stakeholder Issues Related to the Future of the Retirement System and Forms of Benefit Payment

Stakeholders impacted by the payout period and forms of benefit payment include individuals, employers, financial services companies, and policymakers. The issues affect stakeholders in differing ways, yet, are driven, to a large extent, by the interaction among them. Individuals are being asked to take on more responsibility. As the DC system matures, individuals will have more responsibility for decisions even if there are no further system changes. Employers are also likely to focus more in the future on what they are doing for the payout period, regardless of whether there are policy changes or not. New products are also likely to emerge giving employers added opportunities and flexibility. Financial services companies will want to offer products that address the needs of other stakeholders. As individuals are taking more responsibility, policymakers are likely to respond with a focus on issues surrounding distribution and may well recommend and implement policy changes.[8] Key questions for each of these stakeholders are presented below.

Individuals

Individual decisions will drive the timing of labor force exit and whether it is a one-time event or a gradual process. They will also drive the use of resources. The decisions are driven by a combination of personal preferences, resources available (or the individual's evaluation of the resources available), signals, and societal expectations. They may also be driven by influences such as job loss, illness and family member needs.

Some of the decisions also involve difficult trade-offs. Some of the decisions are irrevocable and others are not, and some are required at specific times. For example, an employee with an employer-sponsored DB benefit must choose the form of benefit payment within a certain number of days after retirement. DC plans vary with regard to how quickly decisions must be made and the form of payment of plan funds.

Some of the questions individuals need to focus on include:

- How long can I and should I work? How do I preserve the option to work?
- What is the best time for me to claim Social Security? What about my spouse?
- What is the best way to manage funds postretirement and how long do the funds need to last?
- If I pay off my mortgage, how does that change the decisions I need to make about the need for regular income?
- What is the impact of the Required Minimum Distribution requirements that apply to 401(k) plans and Individual Retirement Accounts (IRA) on my postretirement money management?
- Can I live on my investment income plus Social Security and income from defined benefit pensions? Do I need to draw down asset balances?

[8] This was a topic for the 2008 ERISA Advisory Council and the topic of a recent paper on policy by the OECD. As indicated earlier, it has also been studied by the U.S. DOL and Treasury over the last two years.

- Should I purchase an annuity, long-term care insurance, supplemental health insurance or other financial products? If so, when, and what should be considered in the choice?
- Would a rollover IRA that includes income options be a good idea?
- What challenges will my spouse face when I am no longer here? What challenges will I face if my spouse predeceases me?
- If I can't afford to do all of the things I want to do, how do I set priorities? What is most important?
- If I work on a reduced basis, when do I need to start using previously accumulated resources and drawing down savings?
- How can I balance good management of money and risk protection while also taking advantage of tax deferral and preferences?
- Do I need to downsize? What are my options for doing that? How much do I need to reduce expenses to afford retirement?
- How important is it to get advice? How can I find trustworthy, financial planning advice on managing risk, proper investments, and potential bequests? What is the role of my employer in offering or securing such advice? How much should I expect to pay for advice?
- How can I preserve my health? What do I need to do to respond to health problems?
- How do I integrate thinking about housing with planning for the postretirement period?

The issues reflect a combination of financial decisions with other life decisions. They interact and should be considered together.

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

- 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 are not typically based on sophisticated analysis, nor on any quantitative analysis.
- Reducing spending is the most popular risk reduction strategy.
- Control of assets is an important issue, but many people are not able to exercise that control well.

It should be noted that the Required Minimum Distribution (RMD) seems to act like a default for many people.

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, so assets values will continue to grow. 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 its personal default option for withdrawing DC funds. This is an argument for making income-based arrangements defaults or options, but not mandatory.
- The group in the middle will be most affected by the distribution options and defaults included in DC plans. This group has DC and other financial assets and needs retirement income. Members in this group 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 provided perspectives on how individuals view retirement issues and challenges. 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 calculate 6 percent of assets and compare to expenses (less income from other sources) and use this as a measure of affordability of retirement. It should be noted that while the focus groups found this as a way retirees had thought about whether they could retire, 6 percent is not recommended as a level of withdrawal from retirement funds.
- 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 2009 Risks and Process of Retirement Survey can be found at www.soa.org.

Employers

The next stakeholder to consider is the employer. Many employees today work for multiple employers during their careers. Depending on the organizations' philosophy and talent management program, employees nearing retirement age may be mostly long service, or they may reflect a wide range of service. Employers will differ in their sense of responsibility to employees, with some focus on the period of service at retirement. Some key questions employers need to focus on as they plan include:

- What, if any, responsibility do we have to help employees manage after they leave the labor force?
- What role(s) do we want to play?
- Given the trend towards DC plans, what considerations should go into our decision about whether to simply pay a lump sum and leave the management of assets postretirement to the employee, or to offer other options?
- Would a rollover IRA that includes income options be a good idea?
- Should we offer education and/or advice to help employees manage postretirement? What signals should we send to employees about desirable strategies?
- How can we take advantage of group purchasing of risk protection products to enable our employees to get a good deal?
- Do regulations prevent us from doing what we think would work best to help employees in retirement?
- What impact does our strategy have on our fiduciary responsibilities and liability?
- How can we provide input into policy discussions about the postretirement period?

Traditionally, employers offered income through DB plans, and there were no special problems to focus on. However, most DC plans 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. These plans have evolved, 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, because 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 cited by a benefits manager 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 should be important issues in achieving success and meeting plan goals. Satisfactory results postretirement 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 and in addition, regulatory issues in the United States, such as joint and survivor annuity and spousal consent requirements, annuity provider selection responsibilities, and/or fiduciary responsibilities, and so on, create more work and uncertainty. The testimony provided to the Treasury and DOL earlier in 2010 provides insight on employer issues and again makes clear that employers see complexity in offering life income options directly in the plan. Out-of-plan rollover options are much more attractive.

Exhibit I shows some of the considerations related to in-plan versus out-of-plan options.

Exhibit I
In-Plan Versus Out-of-Plan Options

Issue	**In-Plan Annuity Options**	**Use of Rollover Arrangement Offering Access to Life Income**
Spousal consent	Required	Not required
Institutional pricing for annuity	Yes	Yes, depending on arrangement
Basis of annuity pricing	Requires unisex rates, but individual annuities are priced on sex-based rates	Sex-based rates
Competitive bidding for each participant	No	Yes, depending on arrangement
Complete flexibility for partial purchase and flexibility of timing	Limited by plan—probably not too much flexibility	Depends on arrangement—can offer complete flexibility
Would allow timed purchase of annuities (like dollar cost averaging)	Probably not	Yes, depending on arrangement
Allows access to a wide range of options for unusual situations	No	Yes, depending on arrangement
Works well for employees who have benefits from multiple jobs	May be awkward	More likely to work well

As indicated above, millions of participants have access to IRA rollover arrangements allowing institutionally priced annuity purchase, through contracts made by their plan sponsors directly or through the service providers working with their plans.

Installment payment options can be offered in or out of the plan. They are not as complex as life annuity options.

Financial Services Companies

Given the aging of the population and the greater need of the population for asset and risk management during retirement, there are large opportunities for financial service companies. Financial literacy issues create both challenge and opportunity. Many people do not have the skills to manage well on their own, but they are often unlikely to be aware of this. In addition, their resources may be inadequate.

Key questions for financial service companies include:

- What products do individuals want and need?
- Does our organization want to participate in the IRA rollover arrangements described earlier?
- What products are appealing to employers to include in employee benefit plans?
- How can companies overcome reluctance on the part of employees to make irrevocable decisions?
- Are their gaps in what can be offered today?
- What regulatory hurdles must be addressed to develop new products?

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 rollover 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 postretirement period is viewed as a very important opportunity by many people today. They range from savings and investment funds and products, distribution products from mutual funds, and 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 and 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 fully protect purchasing power, 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 their 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 antiselection and change the risk pool. Variable annuities can offer longevity guarantee without the extra cost of investment return guarantee.

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.

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 and 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.

Policymakers

Policymakers should represent the interest of society or the public at large. The challenges facing U.S. policymakers today are many. Budget deficits, implementing the 2010 health care legislation, unemployment, a slow economy, and terrorism and the response to it define a background of limited resources and great need as policymakers focus on changing demographics, the social safety net, and supporting retirement security. The Federal government is the primary regulator of DC plans, and a mixture of state and Federal agencies regulate financial products. Policymakers are confronted with a world in which lump sums are the usual method of payout in DC plans, and problems with financial literacy are well documented. As they deal with the details of policy as it affects the payout period in DC plans, they are faced with these questions:

- What measures are needed to ensure that demands on the social safety net do not grow or become unmanageable?
- What, if any, policies should be used to encourage retirement at particular points in time or under certain conditions?
- How should policy encourage/support certain strategies during the payout period?
- Should governmental agencies take an active role in education about the payout period?
- How much choice should be allowed or encouraged, and what types of disclosures should be mandated?
- What should be permitted as default options and what types of "nudges" would be effective and permissible?
- Should there be restrictions on the use of lump sums in primary retirement plans?
- Should spousal rights be protected when lump sums are used and how?
- What, if any, payment forms should be mandated and under what conditions?
- What compromises would be acceptable to stakeholders?
- What age restrictions should there be on when retirement benefits are allowed to be paid?
- What requirements should be imposed to prevent excessive sheltering of funds from income taxes?
- What can be done to facilitate offering risk protection linked to DC plans, and to make it attractive for employers to offer employees access to group purchase of risk protection?

There are a separate set of questions that must be addressed with regard to financial service company products and financial planning services.

Primary Forms of Benefit Payment at Retirement

The OECD paper, "Forms of Benefit Payment at Retirement" sets forth three main options (or combinations thereof) for the payout phase to allocate assets accumulated in DC plans. Definitions of the options are:

- ***Lump sum.*** *A single payment.*
- ***Programmed withdrawals****. A series of fixed or variable payments whereby the retiree draws down a part of the retirement capital (and continued investment earnings thereon). Any amount remaining in the retiree's account at his/her subsequent death belongs to the estate and is paid to the retiree's family and other beneficiaries. If the retiree lives to an advanced age, there is a clear possibility (under some programmed withdrawal arrangements) of the payments becoming very small in the later years. Under other arrangements, there is the risk of the capital being completely exhausted before death. "Annuities certain" are a specific form of programmed withdrawals.*
- ***Life annuity****. A stream of payments for as long as the retiree lives. There are also life annuities with additional guarantees, with continued payment to the surviving spouse, with escalation of the benefits in payment, etc.*

Source: OECD, "Forms of Benefit Payment at Retirement" by Pablo Antolin, Colin Pugh and Fiona Stewart, September 2008.

Exhibit II provides a comparative overview of the main features of each of the options.

Exhibit II
Main Retirement Payout Options and Features

	Provides Flexibility Liquidity	**Provides Protection Against Longevity Risk**	**Provides Bequest**
Lump sum	Yes	No	Yes
Programmed withdrawal[9]	Yes	No	Yes
Life annuities	No	Yes	No

Source: OECD, "Policy Options for the Payout Phase" by Pablo Antolin, September 2008.

Note that lump sums can be rolled over into Individual Retirement Accounts (IRAs) in the United States. IRAs preserve tax benefits during retirement. An amount at least equal to the Required Minimum Distribution (RMD) must be withdrawn from the IRA each year and tax will be paid on that amount. IRAs will normally be used by those people who plan to preserve as much tax-deferred asset value as possible.

[9] Programmed withdrawals are also called phased withdrawals or allocated pensions (*e.g.* in Australia) and systematic withdrawals by some U.S. authors.

Current Distribution Practices in the U.S. Retirement System

The strategies in Exhibit III provide a range of methods for setting up programmed or 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, and they can be applied to funds accumulated in a DC plan or through personal savings. 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 under current U.S. practice is the RMD.

It should be noted that annuity purchase is irrevocable, whereas programmed withdrawals can be changed at any time. It is also possible to shift from programmed withdrawals to annuity purchase at any time, or on a staggered basis.

Exhibit III
Examples of Programmed or Systematic Withdrawal Strategies
As Currently Used in the United States

Spending rule	**Examples**
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 pretax 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.

Role of Public Programs, Taxes, Defined Benefit and Defined Contribution Plans

Note that retirement resources can be built inside a formal retirement program or through personal savings. They can be built in a tax protected plan or in after tax savings outside of a defined plan.

Role of Public Programs: U.S. Social Security benefits are paid as a life annuity indexed for inflation. Benefits can be claimed between age 62 and 70, and there is a substantial difference in the amount of monthly benefit depending on claiming age. Social Security is the largest source of retirement resources for many lower and middle income Americans, and it is virtually the only source for many of those with smaller resources. Medicare benefits start at age 65, and they can be viewed as an indexed life benefit.

Role of Taxes: Funds in qualified plans (employer sponsored programs and Individual Retirement Accounts (IRAs)) accumulate tax deferred. Employees contribute pretax dollars and investment income is also tax deferred. A key part of distribution practice is to maintain tax-deferred status of funds as long as possible. Tax law sets forth the minimum requirements for withdrawal from tax-deferred funds through the Required Minimum Distribution (RMD). The RMD acts as a "default distribution option" for many people. Roth IRA programs allow an alternative for tax-preferred retirement savings. Post-tax dollars are saved and investment income is tax-free.

Role of Defined Benefit and Defined Contribution Plans: Pension plans were established as income replacement and to help workers retire in an orderly fashion. In the past, defined benefit plans that had normal payment choices of life income and survivor benefits were the primary base layer for private sector retirement plans. However, this has shifted so that DC plans are much more 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 are often rolled over into a tax protected account. Many plans now offer rollover into special IRAs that include annuity purchase options at institutional prices. Risk protection options, such as the use of DC funds for purchase of long-term care and supplemental health benefits, cannot be directly linked to DC accounts in the current U.S. environment.

International Practice

Exhibit IV presents examples of differing benefit payment methods used globally. At one extreme are plans that pay benefits only (or nearly always) as a lump sum. This is common in the United States. At the other extreme are plans that require benefits to be annuitized without any option. As well, combinations of particular options are often applied. For all of these, local practice will dictate the extent of involvement of the employer and its obligations.

Exhibit IV
Variation of Methods of Benefit Payment in Different Countries

Strategy Type	Countries	Comments
Lump sums only	Hong Kong, India, Luxembourg, Philippines	Applies for Mandatory Provident Fund in HK, India, Philippines.
Lump sum or programmed withdrawals	China PRC, Indonesia, Malaysia	Programmed withdrawals can be provided through the plan.
Wide range of options	Australia, Brazil, Denmark, Japan, Singapore	
Lump sum or life annuity	United States, South Africa, Greece, Spain, Switzerland	In United States, lump sums dominate.
Partial lump sum option with mandated life annuity for balance	Italy, Portugal, United Kingdom	In United Kingdom, programmed withdrawals allowed until age 75 and then annuitization is mandatory.
Life annuity or programmed withdrawals	Argentina, Canada, Chile, Costa Rica, Norway	Costa Rica (mandatory plan aimed at replacing Social Security with minimum guarantee).
Life annuities only	Austria, Bulgaria, Croatia, Germany, Netherlands, Poland, Sweden	Bulgaria (mandatory second pillar), Germany (occupational pension plans).

Data from pages 19-20 of OECD paper “Forms of Benefit Payment at Retirement” by Pablo Antolin, Colin Pugh and Fiona Stewart, September 2008.

There is a growing emphasis worldwide on the payout period. This topic was a major area of focus for the U.S. Treasury and Department of Labor in 2010, was explored at the 2008 ERISA Advisory Council, and was a recent area of focus for the OECD. Retirement plan participants are likely to be more concerned about a secure income stream in light of the recent economic crisis. As a result, policy and practice are under study in many countries and change is likely. In countries where lump sums are the primary payout method, there is concern about whether pension assets are being spent too rapidly. In countries that mandate annuitization, there is concern about a lack of an individual’s control over pension assets and the possibility of easing that requirement. Another factor to bear in mind is that tax treatment varies by country. The OECD is focused on that issue, and a 2008 paper[10] provides an overview of the policy issues and recommendations.

[10] Antolin, P. “Policy Options for the Payout Phase”, OECD Working Papers on Pensions and Private Insurance Number 25, OECD.

The Impact of Choices, Timing, and Literacy in the Retirement Decision Process

In some countries a variety of choices is common and in others, there is limited or no choice. When a lump sum is paid, the individual has the greatest choice of how to invest funds, and depending on the market, the individual can then choose to buy an annuity. Where choices are permitted, the situation is more complex because some decisions are irrevocable. Once an annuity is purchased, it is usually locked-in. Other strategies can be changed over time. Also, from a purely financial management point of view, if annuities are to be purchased, in many cases it will be better to spread the purchase over time, but it may not be feasible to do this, and individuals may not be able to manage such a spread even if feasible.

How people will act when they have choices is influenced by what people know. Research has repeatedly shown significant gaps in knowledge about retirement. The author's general observations from such research are that:

- Financial literacy needs improvement. Many Americans do not understand basic math including compound interest and percentages.
- Many individuals are short-term focused as they plan for retirement. Retirement planning often does not include serious and deliberate analysis of life and financial issues.
- Lump sums are overvalued when compared to the present value of an equivalent income stream. The lump sum is often perceived to have a greater value because it represents a larger sum of money in a single amount than most people have dealt with previously.
- Many individuals are overly optimistic about expected returns on investments and the ability to manage investments. In addition, some individuals who can manage investments at retirement may not be able to do so later, particularly if they become incapacitated in some way.
- 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.
- There is a lack of understanding about financial products that are useful in helping to mitigate risk and when they might be most helpful. Surveys by the Society of Actuaries indicate that the most commonly used risk reduction strategy is to reduce spending.
- For many people, a great deal of change occurs during retirement as individuals pass through different phases. However, planning often focuses only on the immediate phase after retirement.

Investment decisions by individuals who retired with DC account balances

A 2008 Investment Company Institute survey[11] 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 they had no choice. The disposition of the accounts was reported as shown in Exhibit V.

Exhibit V
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, 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 indicate how successful the decisions were in the long run. That is, it is unknown 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.

[11] Defined Contribution Plan Distribution Choices at Retirement, Fall 2008, Investment Company Institute.

The Society of Actuaries, LIMRA and InFRE conducted two studies in 2008 and 2009[12] to understand investment decisions by retirees with at least $100,000 in assets and the rationale behind those decisions. The 2009 study was a follow-up to the same respondents of the 2008 study to learn how the economic crisis had affected the respondents and their decisions.

The first study showed the following:

- Forty-five percent of the respondents were not receiving enough money from Social Security and DB pensions to cover basic living expenses, but there was little interest in the purchase of annuities or guaranteed income products. Sixty-four percent of the respondents were receiving income from DB plans.
- Ninety-five percent of the respondents were confident that their investments were being managed well.
- Forty percent of the respondents did not withdraw any money from their investable assets in 2007 (the prior year).
- The story was mixed with regard to planning, with some having done a great deal of planning and others very little. Three in 10 had not considered how long-term care expenses would be paid.

The follow-up in 2009 indicated that:

"Overall, it is evident that the financial crisis has impacted aspects of the current mindset and financial outlook of these retirees. Retirees now:

- *Feel less secure after the crisis*
- *Are less confident that they have saved enough for retirement*
- *Have become more conservative and less willing to take risk*
- *Are trying to control spending*
- *Are more likely to have a personal financial advisor"*[13]

[12] Society of Actuaries, LIMRA and InFRE, "Will Retirement Assets Last a Lifetime", 2008 and "What a Difference a Year Makes", 2009.

[13] Society of Actuaries, LIMRA and InFRE, "What a Difference a Year Makes", 2009.

Putting It All Together: U.S. Reality Today

This discussion is focused largely on middle Americans with account balances in DC plans. This part of the population needs those account balances for retirement.

- Lump sums are the primary method of payout in DC plans, and this is unlikely to change, at least for the next few years.
- Rollover IRA products that give retirees access to purchase of annuities as well as other options at attractive prices have good acceptance.
- Taxation is an important factor in determining the best strategy for individuals in using assets. Situations vary by individual.
- Mandatory life income from DC plans, or mandates requiring income options, are not on the horizon.
- At least in theory, there is good reason to revisit defaults in DC distribution, but this does not seem to be on the horizon.
- Short-term planning horizon and gaps in knowledge are real problems.
- For many people, risk management including long-term care planning, planning for longer life, and planning for the death of one spouse is not a high priority.
- RMDs have a big influence on how money is withdrawn from plans.
- There is very good material available to help people nearing retirement, but there are still many people who do not plan well.
- Many middle-class people have most of their money in housing, and often they do not have enough to retire without a significant reduction in spending power.
- Addressing challenges today is about equipping people for making decisions and encouraging better decisions.
- Longer term, there may be changes in the policy environment that would shift the landscape.

Taking Action Today: Individuals Making Informed Choices

Information Needed by Individuals Not Yet Approaching Retirement Age

These individuals need to understand how much they should be saving, their account balance, and their progress towards reaching their retirement goal. They should also have information that builds expectations and promotes the idea that retirement assets need to generate income replacement. Individuals need to have information to help them consider investment in housing versus saving more for retirement and tools to evaluate saving/spending decisions.

Information Needed by Near-Retirees

This is a critical time as some individuals will be making the most important financial decisions of their lives. Below are a number of messages and themes that will support people at this juncture of their careers as they prepare to embark upon retirement:

- Importance of having a longer-term planning horizon
- Importance of knowing what strategy will be used to replace the paycheck, and knowing that paycheck replacement will adequately cover expenses
- Impact of earlier versus later retirement, including the effect on Social Security, pensions, and how long assets are likely to last, and a method to evaluate how this will affect them
- Variability and potential length of lifespan
- 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 having a strategy for long-term care needs
- Understanding whether buying risk protection products would be appropriate
- Basics regarding investing in retirement and alternatives for obtaining advice
- Understanding of options with regard to housing, including potential to pay-off mortgage, downsize, sell and rent, increase mortgage, etc.
- Realistic assessment of potential and options for continued work as part of retirement

Some Key Decisions at or Near Retirement

When people are arranging for their retirement finances, it is important to understand essential expenses going forward and income sources to meet those expenses. If there is a big gap, a variety of strategies can be considered including delaying retirement. Some other strategies to consider include:

- Delayed claiming of Social Security—this is somewhat like buying annuity income at a favorable price
- Paying off mortgage—this reduces monthly payments, but also reduces assets available for investment
- Reducing expenses to make life more affordable including downsizing housing.

These decisions may be preliminary to thinking about the possibility of annuity purchase, and, of course, they may not be feasible in all situations. Planning is the first step for the individual.

Taking Action Today: Plan Sponsor Strategies

What Plan Sponsors Can Do

Employers and other plan sponsors 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 the employee is faced with the lifetime paycheck replacement issue. In this case, the author hopes that the employer will at least introduce the idea of regular 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 endorsement of the idea of life income and encourages a focus on life income 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.
- 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. Many employers are choosing to use the IRA rollover route rather than putting options in the plan, or they are limiting options in the plan.
- 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. This is not a common strategy today.
- Advising—Employers have different views about engaging people to advise employees. The most common focus of advice is a general discussion of the asset issues needed for general investment planning. In the future, employers who are advising about investments 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 postretirement security.
- Acting as a resource for information.

A Practical Solution—What Plan Sponsors Should Do

This leads to the author's recommendations about what employers and other plan sponsors 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, and the importance of protecting the survivor and how different approaches fit into that.

Offer access to annuities through rollover IRA program. This is the easiest method to enable employees to get access to life income with institutional pricing, many options, and virtually no cost for the employer.

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 (or provide access to) other sources that provide the following types of information, signals, and messages to help employees manage during the postretirement 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 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.

Focusing on the Future: Longer-Term Policy Issues; Responding with Defaults, Options and Mandates

As discussed earlier, there are in theory a variety of different forms of benefit distribution, and they can be offered on a mandatory basis, as a default, or as an option that the participant chooses. Defaults and options are a key part of plan structure, they can come in many different forms, and they can be determined by law 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 received much attention in some areas, but little attention has been paid to payout period defaults. Safe harbors are available in the United States for investment defaults but not distribution options. Defaults are an area where there is a significant possibility that there will be policy change and the future may not look like the past. This is one of the areas explored by the Society of Actuaries Retirement 20/20 initiative. Here are theoretically possible approaches to default options for the payout period, although policy change would be needed to enable some of them in the United States:

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.

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 a 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 because it enables individuals to choose virtually any market payout option within a tax-protected plan.

Focusing on the Future: Recommendations for the Payout Period[14]

Longer term, stakeholders need to work together and employers may want to think about a more activist role in the payout period. Here are some ideas:

- **Enable use of DC funds for risk protection—**Change DC regulatory structure so that 401(k) funds could be a retirement risk protection account, and after retirement, balances could be used to purchase a variety of risk protection options, either through the plan or through employer offerings on an advantageous basis. Some of the choices should include lifetime income with survivor protection, with or without inflation protection, supplemental health insurance, and long-term care benefits. These choices should be available in rollover IRAs or in direct options.
- **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 the past decades, there has not been much innovation in payout management. New possibilities for options and defaults should be encouraged. Public discussion is needed to reach consensus on what should be allowed, what should be required, and what should be protected in a safe harbor.
- **Facilitate group purchasing of financial products for voluntary purchase—** This would enable employees to obtain 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 to hold funds until an annuity is purchased.
- **Restructure or eliminate RMD requirements—**As they exist today, RMD requirements often become the DC distribution default.
- **Explain trade-offs—**It is clear that many individuals do not make well-informed choices about retirement and the management of funds postretirement. The trade-offs involved in the choice of a strategy are extremely important, and not easy to understand. Better information from good unbiased third parties can be made available to explain 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.
- **Encourage communication focused on life or at least long-term income—**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 propel the participant toward or away from regular income.

[14] These recommendations were included in testimony by Anna M. Rappaport to the ERISA Advisory Council in September, 2009

Conclusion

Managing resources and income in retirement is a very important part of the total retirement income picture for the future. At the time of leaving work, particularly at time of retirement, key decisions must be made that will affect the disposition of retirement funds, particularly DC plan assets. Retirees face many risks, often without perfect solutions or enough resources to address them all. Rollover IRAs offer good options today. We should remember that defaults are an important influence whenever people act. Yet today most of the focus on defaults has been on areas other than the payout period. A multipronged approach to the payout period is needed with a more active role for the employer in supporting DC distributions, matching of products to consumer preferences, education of the individual, and the updating of regulation regarding the payout period.

Appendix

Exhibit VI
Types of Income Streams and Risk Distribution

Option, Risk Distribution and Comments	Advantages	Disadvantages
OPTION: A guaranteed life income for the life of the participant and spouse (or the participant only) Provider of income stream assumes mortality and investment risk, may assume all or part of inflation risk Individual assumes some solvency risk (Only choice in Social Security and default option in private sector DB plans and most public sector plans as well)	Income guaranteed for life—if inflation indexed, preserves dollar value in payments, if not, it does not Larger income than other options because of "mortality dividend" (amount not paid to others who die early is redistributed to those who live long) Investment management responsibility transferred and in the hands of professionals, but relatively low rate of return	Lack of liquidity and inability to change decision later Option is locked in, can't be changed later Generally no death benefit after second dies, so principal lost if both die early Potential for gain through good investment decisions is lost, but risk also transferred Cost of guarantees for longevity, investment return and expenses
OPTION: An immediate variable annuity—an income for the life of the participant and spouse (or the participant only) with the amount of payments varying based on investment experience *Provider of income stream assumes mortality risk and offers several professionally managed investment funds* *Individual selects investment funds backing annuity and assumes the related investment risk*	*Income guaranteed for life* *Same "mortality dividend" benefit* *Investment management responsibility transferred and in the hands of professionals, but investment gains or losses are passed on to individual. Can result in larger income if returns exceed the assumed interest rate (generally 4%)* *Investments can be changed at any time during payout period, there is no locking in of investments*	*Lack of liquidity* *Option is locked in, can't be changed later, although investment decisions can be changed at anytime* *Generally no death benefit after second dies, so principal lost if both die early* *Potential for declining income if investments do poorly* *Cost of guarantees for longevity and expenses, but not investment return*

Option, Risk Distribution and Comments	Advantages	Disadvantages
OPTION: Installment payments that allow for payment of principal and interest over time without any life or investment guarantee *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* *Individual may assume some solvency risk depending on financial institution used*	*Larger income than interest only and smaller than life annuity* *Unpaid balance after participant (and spouse or beneficiary if applicable) dies goes to heirs* *If good investment experience, funds can go up a lot* *Strategy can be modified later*	*Payments not guaranteed* *No mortality dividend* *Potential for outliving assets could leave people financially vulnerable in old age* *If funds invested in risky investments, payments can go down a lot if poor performance, and they will fluctuate over time*
Option: Payment of investment earnings only *Individual bears mortality risk and investment risk*	*Preserves capital for future needs, emergencies and heirs* *Strategy can be modified later*	*Smaller payments* *Depending on investments and distribution method, payments may be very unequal from year to year*
OPTION: Systematic withdrawal strategy *Individual bears mortality risk and investment risk* *There is a range of such strategies—See Exhibit III for description of several strategies*	*Smoothes out payments if fixed amount, varying amount if based on paying percentage of varying asset base* *Can be designed to preserve principal* *Strategy can be modified later*	*May not work out well if poor investment results* *If withdrawals are too large, great chance of running out of money*

Option, Risk Distribution and Comments	Advantages	Disadvantages
Option: Home ownership—provides a means of reduced cash outlay to the individual *Individual bears risk of change in value, need for repair, etc.* *While this is not a strategy to produce income, it is used in lieu thereof*	*Many people prefer to stay in their own homes in retirement* *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* *If home becomes unsuitable, it can be sold, but market may be very difficult* *Using house equity as an asset may offer way to minimize tax liabilities*	*Too much asset may be tied in home* *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* *Individual may not have adequate means to live on*
OPTION: Home ownership—use reverse mortgage to convert value to cash *Could be packaged with lifetime guarantee*	*Allows staying in home and getting some benefits of income* *Product may include a lifetime guarantee*	*Disruptive if home needs to be sold* *May be very expensive way of securing funds*

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.

Risks in Retirement

The risks in retirement are complex and interacting. Exhibit VII draws heavily from the risk analysis developed by the Society of Actuaries in conjunction with its Risks and Process of Retirement Surveys conducted biennially from 2001 to 2009.[15] The results from the surveys provide information about how retirees view these risks and what is most important to them. This survey series and other related efforts indicate that there is considerable misinformation about risks. Any of these risks can have an immediate and significant impact on the payout period.

Exhibit VII
Risks Facing Retirees and Comments About Their Management

Risk	Products and Approaches for Risk Transfer and Potential for Pooling	Comments
Outliving assets (Impact of this risk is most often at the high ages)	Annuities, including joint and survivor annuities and deferred annuities commencing at higher ages such as 85 (longevity insurance) The OECD report focuses on programmed withdrawals and longevity insurance starting payments at age 85 as a good combination DB plans often automatically provide life income Risk transfer not needed if investment income without using assets exceeds expenses A few inflation adjusted annuities are available, and annuities without inflation adjustment provide only partial protection	Consideration of both spouses is needed in designing a strategy 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) Programmed withdrawals and bond ladders offer other strategies to produce long-term income, but not income guaranteed for life Programmed withdrawals are more popular than bond ladders
Loss of spouse (Impact can be at any age)	Joint and survivor life annuities, life insurance Long-term care insurance helps protect assets that may be left to spouse	Social Security offers a base layer of protection For women, periods of widowhood of 15 years and more are not uncommon

[15] Society of Actuaries, 2009. The reports from the risk survey can be found at (http://new.soa.org/research/research-projects/pension/research-post-retirement-needs-and-risks.aspx). (Note that there are several separate reports—a full report on the survey and added reports that focus on specific portions of the results.)

Risk	Products and Approaches for Risk Transfer and Potential for Pooling	Comments
Cost of disability and long-term care (Can be any age but long-term care most likely at any time)	Long-term care insurance Continuing care retirement communities Medicaid pays for cost for many people without assets or income	Currently, nursing home costs can exceed $70,000 per year Care can be provided at home, in an assisted living facility, adult day care center, or nursing home
Cost of acute health care	Medicare for those who are over age 65 Medicare supplemental insurance including employer-sponsored retiree health benefits	For early retirees, there is a major problem if they do not have employer coverage; health care reform may help
Investment risk, inflation and interest rate risk	Investment strategies can reduce risk; some products provide minimum guarantees Inflation protected bonds Annuity products with cost-of-living adjustments	Strategies that work well when assets are being built may not work well during the period when assets are being used
Inability to find job, loss of job	No way to pool on a longer-term basis	Many individuals are thinking of working longer to address inadequate savings and loss due to market downturns, but it is not clear if that will be feasible
Family members needing care	No way to pool	Situations vary with regard to the availability of family members to help

Several of the risks shown in Exhibit VII can be pooled and transferred. 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 expected to, often because of job loss, poor health, or family issues.

The major concerns of retirees and pre-retirees were documented in the Society of Actuaries Risks and Process of Retirement Survey series. Key findings of the surveys included the following:

- Pre-retirees are much more concerned about risk than retirees.
- There has been little change in the retiree perceptions about risk over the years.
- Pre-retirees became more concerned generally about risk between 2001 and 2003, not surprising in light of the September 11th events and the poor equity markets, but they have reduced their concern from 2003 to 2007.

- There was no similar significant shift in pre-retiree risk concerns from 2007 to 2009.
- 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 information on how individuals make choices through the work of behavioral economics.

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Anna Rappaport is an actuary, consultant, author, and speaker, and is a nationally and internationally recognized expert on the impact of change on retirement systems and workforce issues. She is passionate about creating a better future for older Americans, improving the retirement system in America, and is particularly concerned about the many women who do not fare well at older ages. Anna Rappaport chairs the Society of Actuaries Committee on Post Retirement Needs and Risks and has been a leader in the development of an extensive set of research on the postretirement period. Anna formed Anna Rappaport Consulting in 2005 after retiring from Mercer Human Resource consulting at the end of 2004 having served 28 years with the firm. Anna completed 45 years as a Fellow of the Society of Actuaries in 2008 and has a Master's of Business Administration from the University of Chicago. Anna previously served as President of the Society of Actuaries and serves on the Boards of the Women's Institute for a Secure Retirement (WISER), and the Pension Research Council. She currently serves on the ERISA Advisory Council and the GAO Retirement Security advisory panel, the Retirement 20/20 advisory group, and the EESI advisory group. She is a member of the Chicago Network, an organization of the top women in Chicago from all walks of life. She was appointed Senior Fellow on Pensions and Retirement by The Conference Board in 2007. She testified before the ERISA Advisory Council on phased retirement and defined contribution distributions in 2008 and participated in a Working Group on phased retirement as part of Workplace Flexibility 2010 at Georgetown University Law School.

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