For decades, employers have assisted their employees with accumulating wealth for retirement through sponsorship of defined contribution (DC) plans. As more employees reach retirement age, employers are beginning to ask themselves, “What should we do to help our employees ensure they have income for life after retirement?” Government agencies and industry groups are trying to help employers answer this question.

This article looks at historical background around retirement as well as recent developments on the issue.

Background

People are spending more years in retirement. Average life expectancy rose by 2.9 years from 1970 to 2000, increasing the time spent in retirement by nearly 20%, from 15 years to 17.9 years. In addition, people are forced into retirement earlier than expected for reasons beyond their control. In 2010, 41% of retirees surveyed by the Employee Benefit Research Institute said they retired earlier than planned, most because of health problems or disability.

The definition of retirement is changing too. Retirement in the past was often defined by age. At age 65, many workers would receive Social Security and employer pension benefits sufficient to allow them to continue a standard of living in retirement equal to their pre-retirement years. Today, fewer 65-year-olds have enough wealth from employer-sponsored retirement programs and personal sources to sufficiently supplement their Social Security payments to maintain their pre-retirement standard of living. For them, retirement is defined as the time when they are no longer able to earn a wage, regardless of age.

People rely more on 401(k) accounts than before. Employers have been shifting from defined benefit (DB) plans to DC plans, and the trend is expected to continue. In 1996, the approximate asset totals in private DC plans were the same as in private DB plans, both holding about $1.6 billion. By 2040, there will be an estimated four times the assets in DC plans as in DB plans. In shifting from DB to DC plans, employers are transferring many of the risks related to retirement to the individual, including funding, investment, and longevity risks.

All of these factors – more years in retirement, lower wealth accumulation, and greater reliance on DC plans – are fueling the increased interest in how to help individuals manage their DC accounts to provide adequate retirement income.

Feedback to the DOL

On February 2, 2010, the Department of Labor (DOL) issued a request for information “soliciting public comments to assist the agencies in determining what steps to take to enhance retirement security for workers in employer-sponsored plans through lifetime annuities or other arrangements that provide a stream of income after retiring.”

The RFI asked for comments on a broad range of topics, including:

- The advantages and disadvantages of distributing benefits as a lifetime stream of income, both for workers and employers, and why lump sum distributions are chosen more often than a lifetime income option.
- The type of information participants need to make informed decisions in selecting the form of retirement income.
• Disclosure of participants’ retirement income in the form of account balances as well as in lifetime streams of payment.
• Developments in the marketplace that relate to annuities and other lifetime income options.

The DOL gathered comments through May 6 and received 700 submissions. The submissions can be viewed and downloaded at www.dol.gov/ebsa/regs/cmt-1210-AB33.html.

Many of the respondents were individual citizens expressing their concern about any future involvement by the government in their retirement accounts. Also responding were organizations representing a wide range of stakeholders, including insurance companies, investment managers, labor unions, industry advocacy groups, think tanks, members of Congress, academics, and more.

While not all respondents agreed or commented on every aspect of this issue, there were several themes that appeared repeatedly in the comments. Nine of these themes are discussed below, along with excerpts from some of the respondents.

**Save More** – Retirees may need help converting their retirement wealth into income; however, if they have inadequate wealth to begin with, no product or method will close the gap.

Fidelity: “Accumulating sufficient retirement savings has to be the first priority, because no lifetime income solution can compensate for an inadequate account balance at retirement.”

**Credit Risk** – Annuities involve the transfer of longevity risk from the individual to an insurer. This does not mean the risk goes away. Plan sponsors and participants must be able to make reasoned and informed decisions about the credit worthiness of the insurer to whom they are transferring risk. But is this possible?

Vanguard: “All annuity guarantees are subject to the credit or solvency risk of the insurer … Vanguard has extensive experience evaluating the credit risk of insurers. This analysis requires a high degree of sophistication and needs to go beyond a review of credit ratings to be effective. This degree of analysis would be challenging for many employers, and virtually impossible for individual investors who are being asked to evaluate the credit worthiness of an insurer who could be paying them benefits for 20 or 30 years.”

**Safe Harbor** – Many respondents suggested that the government provide plan sponsors with safe harbor rules that plan sponsors could rely on to relieve them of fiduciary risk when selecting retirement income options for DC plans.

Wells Fargo: “Wells Fargo specifically supports … expanding regulatory safe harbors for plan sponsors who choose to offer lifetime income products within their retirement plans to limit fiduciary exposure.”

ING: “ING believes it is essential that employers and those serving as plan fiduciaries be given the benefit of a streamlined fiduciary standard with more objective criteria than exists today…”

Dr. Olivia Mitchell (Pension Research Council): “Pension plan sponsors will be more likely to offer payout products with longevity protection if additional safe harbor provisions and guidelines are made available.”

**Longevity Pooling** – Respondents were concerned about the possibility of losing their life and money at the same time with annuities. Insurers can mitigate this concern by adding product features that provide guaranteed total payout amounts or certain years of payments, yet these features dilute the most important feature of an annuity – sharing longevity risk. There is no getting around this fact.
The Individual Finance and Insurance Decisions Centre: “The fundamental benefit of receiving lifetime income is that longevity risk is pooled across participants – and thus income for surviving participants is subsidized by assets from participants who die, giving rise to what actuaries call ‘mortality credits.’ This basic benefit increases as longevity risk increases. That is, for a given population, the greater the uncertainty with respect to longevity – i.e., the greater the difference in time between the earliest and latest expected death dates – the greater is the benefit from pooling longevity risk.

“The sharing or pooling of longevity risk is fundamentally the only reason that lifetime income has any economic value or financial benefit to the retiree. Accordingly, in our view it is extremely important to emphasize and make clear that (theoretically) if all members of a retirement group lived for the same or very similar amounts of time – or conversely if everyone demanded guaranteed payments for 30 or 40 years regardless of survivorship status – there would be little if any benefit to lifetime income (i.e., annuitization). We believe that the concept of lifetime income is inseparable from pooling of longevity risk.”

Financial Literacy – Many respondents agreed that financial education should be part of the solution.

Investment Company Institute: “Providing high quality information, education and advice should be a shared priority of government and the private sector.”

Allianz: “Allianz recommends that the Agencies consider adopting Rules that encourage defined contribution plans to make enhanced educational materials available. These materials should educate consumers about the value of properly designed lifetime income solutions during the accumulation and distribution phase.”

Existing Annuity (Social Security) – Most workers reach retirement with a meaningful portion of their financial net worth already invested in an annuity – Social Security. This begs the question whether most retirees need further annuitization.

The Profit Sharing Council of America (PSCA): “PSCA asks the Agencies to keep in mind that average wage workers already are provided with a substantial annuity when they retire (Social Security). According to the 2009 Social Security Trustees Report, the average 65 year old retiring in 2009 will receive a Social Security benefit that replaces 40 percent of preretirement income. These annuity payments are subsequently adjusted for inflation. 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.”

Government Mandate – Individual citizens who responded were strongly opposed to government-mandated annuitization of DC or individual retirement accounts (IRA). Even organizations that would economically benefit from government-mandated annuitization expressed their opposition.

New York Life: “… supports policies to encourage annuitization, such as requiring plan sponsors to show a worker’s balance in the form of lifetime income, encouraging plan sponsors to educate participants about lifetime income options, and providing incentives to encourage individuals to annuitize a portion of their retirement savings. However, New York Life strongly opposes policies to mandate annuitization, including default annuitization or ‘auto-annuitization’ proposals.

“Unlike the accumulation of savings, the distribution of savings through annuitization is not a ‘one size fits all’ solution. In addition, auto-annuitization is not an effective way to increase retirement income because
auto-annuitization programs generally would offer a relatively minimal benefit to the majority of workers. A more effective policy approach would be to encourage workers to delay Social Security.”

**Out-of-Plan** – Employers who choose to offer their employees lifetime income options may ultimately choose to provide them outside of their qualified plans.

Vanguard: “We also anticipate that participants will make most retirement income decisions in the context of an IRA rollover account, outside the confines of their employer’s qualified retirement plan. Some plan sponsors have expressed interest in offering retirement income solutions inside qualified plans. However, many more plan sponsors have reservations about in-plan solutions. They are concerned about fiduciary responsibility for selecting and monitoring in-plan retirement income solutions, worried that few participants will actually use the products, and feel that the products themselves are new and present administrative challenges.”

**Complexity** – Finally, we come to the issue that may trump all others—complexity. Complexity causes anxiety; anxiety leads to suboptimal decisions, or worse yet, no decision at all. Retirement income solutions must be easy to understand and use in order to gain popularity.

Charles Schwab: “In our view, an ideal product solution … will (among other features) … [be] simple in structure and easy to understand.”

American Society of Pension Professionals and Actuaries (ASPPA): “We believe [one of the disadvantages with lifetime income products generally is that] there is a level of complexity; that is, it may be difficult to understand the options and benefits.”

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In conclusion, the single most effective way for individuals to ensure that they have sufficient income in retirement is to accumulate more wealth. Their amount of savings defines their options in retirement. This should remain the plan sponsor and participant’s first priority.

Regarding lifetime income options, plan sponsors should be aware of the fiduciary standards that apply to any products they choose, whether those products are placed inside or outside their qualified plans. If the plan fiduciaries are unsure of their fiduciary duties or how to evaluate the lifetime income options they are considering, they should seek expert assistance or refrain from making decisions.

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We will continue to follow developments on the DOL’s retirement security initiatives. If you have questions, please contact your Aon consultant or: Scott Fisher at 206-467-4610, Drew McCorkle at 404-240-6149, Angie Parrish at 813-636-3070, or Martha Spano at 213-630-2070.