Institutional Retirement Income Solutions

A Call to Action

IRIRC White Paper

With defined contribution plan assets projected to be the primary source of retirement income (other than Social Security) for future retirees, pressure is building to design retirement income solutions into DC plans. It is in the best interests of plan participants, plan sponsors, and the industry as a whole to take a proactive stance on providing retirees with a secure lifetime income and discouraging government mandates. The Institutional Retirement Income Research Council was formed to facilitate the adoption of institutional retirement income solutions.

INSTITUTIONAL RETIREMENT INCOME RESEARCH COUNCIL

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Preamble

The **Institutional Retirement Income Research Council** (IRIRC) was created to help employees achieve secure retirement income by supporting and encouraging the retirement industry's dialogue on how retirement income options should be incorporated into 401(k) and 403(b) plans, and to help DC plan consultants and their advisors utilize best practices in their deliberations. Initial support for the establishment of the IRIRC has come from Prudential Retirement. (Prudential Retirement is a business division and registered service mark of the Prudential Insurance Company of America, Newark, NJ and its affiliates.) Other suppliers of institutional retirement income products have provided support in the form of information and other resources. The IRIRC is an independent, unbiased think tank focused on institutional retirement income solutions.

The objective of the IRIRC is to provide practical insights and recommendations on how to incorporate institutional retirement income solutions into DC plans with the goal of helping participants achieve a secure retirement.

The IRIRC is comprised of a dozen consultants and advisors who work directly with plan sponsors and their providers. The breadth of expertise represented on the IRIRC includes academic research, plan design, investments, participant experience, recordkeeping, public policy, and actuarial impacts. This results in a holistic perspective of the current retirement plan environment and what is needed to improve it.

As part of their effort, the IRIRC is developing a series of white papers intended to answer the following questions:

- Why is it important for plan sponsors to consider adding retirement income solutions to their DC plan offerings?
- What are the retirement income solutions available to DC plans, and their distinguishing characteristics?
- How should the retirement income solutions be evaluated and monitored?
- What are the challenges likely to arise from the addition of retirement income solutions to DC plans, and what can plan sponsors and their providers do to anticipate and mitigate them?

Executive Summary

With the transition from defined benefit (DB) plans to defined contribution (DC) plans, the need to continue to evolve and improve DC plans has become critical. In the private sector, the employer-based system has focused on efficiently accumulating savings for retirement, and the rapid move toward automatic enrollment and automatic escalation strategies has proven effective in increasing participation and contribution levels.

However, the current DC approach is now being widely criticized for leaving retiring participants unprepared to manage their savings to generate secure lifetime income. Indeed, according to the Center for Retirement Research, more than $2 trillion of 401(k) and IRA assets was lost during the one-year period ending October 9, 2008.[1] Urgency is building as the risk of retirees outliving their nest eggs continues to escalate due to insufficient savings, increased life expectancy, and poor investment decisions. As a result, potential government mandates are receiving increased attention from policy makers.

[1] "Are Retirement Savings Too Exposed to Market Risk?," Issue Brief 8-16 by The Center For Retirement Research at Boston College, October 2008.

New thinking and a new approach are needed to help employers and their employees with this critical issue. The problem is extremely complex and involves stakeholders from all areas of the retirement industry. Bringing together the expertise of various segments of the retirement industry to solve the problems will encourage plan sponsors to implement the solutions, and to do so sooner. This is crucial because employers are in a unique position to have the greatest impacts.

Retirement income solutions are a necessary next step in the evolution of DC plans because plan participants are ill-prepared to manage the distribution stage on their own. Researchers have documented that poor financial literacy and behavioral bias are significant impediments to the success of individual investors. Building retirement income solutions into DC plans promises to address many of the problems retirees face in generating secure lifetime income.

The success of "automatic" plan features illustrates the advantages of the "libertarian paternalism" approach to solving these types of problems. This approach provides strong encouragement and guidance to plan participants, while still allowing individual choice. A proactive employer can significantly improve the likelihood that employees will achieve secure retirement income, and simultaneously improve the employer's ability to manage their workforce without increasing costs.

Plan sponsors are juggling many priorities, and the ability of employees to retire securely in the future may not seem to be an immediate concern. However, there is significant public angst around this issue, and it is gaining increasing attention from public policy makers, especially with the recent market volatility. There is a growing risk of additional government mandates unless employers move proactively to resolve the problem.

By focusing the attention and expertise of representatives from all areas of the retirement industry, optimal solutions can be brought to bear more quickly. It is in the best interests of all—employers, employees, and those in the industry who serve them—to evolve DC plans from their current focus of *accumulating savings* to *providing retirement income.*

The Evolution of the Employer's Role in Retirement Security

Over the past decade, researchers in the retirement field have focused on the emergence of defined contribution (DC) plans over defined benefit (DB) plans as the primary source of retirement savings and income for most workers. Much of this critical research established that many individuals who had DC plans available to them were making poor decisions.

With the shift from DB to DC, a shift of risk and responsibility transitioned from the employer to the employee. Although employers are unlikely to resume the financial risk they held in the past with DB plans, they are now taking on a more proactive role in helping their plan participants become more successful with their DC plans. Thus far, the focus of "guiding employees" has occurred during the enrollment and accumulation stage of the DC plan experience.

The emergence of automatic enrollment, automatic escalation, and qualified default investment alternatives as common features in many companies' 401(k) plans has proven effective in assisting workers to save and invest appropriately. A Fidelity survey shows that participation rates in plans with automatic enrollment average 81percent, while plans without this feature average only 53 percent.[2]

[2] "Building Futures Volume III," Fidelity Investments, 2007.

The need for these "automatic" features—and their success—is evidence that a large majority of the workforce lacks the time, interest, and/or skills to manage the accumulation of retirement savings without help.

The phenomenon of employers assuming a more active role during the accumulation stage of retirement saving has been referred to as "libertarian paternalism."[3] The "libertarian" description reflects the preservation of individual choice by the employee, and the "paternalism" facet refers to employer-provided direction in the form of intelligent defaults for individuals to follow. For example, a typical 401(k) plan with automatic enrollment will enroll a new employee into the plan while preserving the choice of the individual to opt out if he or she chooses.

This new *proactive* role of the employer in the accumulation stage of the 401(k) experience is now an accepted standard within the DC plan industry, and it will help improve individual outcomes. But many plan sponsors and their advisors are now coming to question whether the success of their DC plans should be based on participation rates, or on whether the plan facilitates adequate retirement income.[4]

Stakeholders in the retirement future of U.S. workers are now shifting their focus to a new issue: ensuring an adequate and secure lifetime income stream in retirement. In a recent survey of benefits consultants and retirement plan administrators, responses were dominated by the following concerns:

- Developing and evaluating retirement income solutions for DC plans;
- Addressing increased longevity risk; and
- Clarifying employee and plan sponsor roles in meeting those challenges.[5]

Evolution of the Sponsor's Role in Participant's Retirement Security

Defined Benefit	Defined Contribution	Future State of Defined Contribution "Libertarian Paternalism"
Focus on income	Focus on accumulation	Refocus on income
Sponsor provides limited options at retirement	Sponsor provides choice	Sponsor sets participant on "sound path" and provides opt-outs
Sponsor bears financial risk	Participant bears financial risk	Participant guided to transfer risk to financial guarantor

[3] "Libertarian Paternalism Is Not an Oxymoron," article in *University of Chicago Law Review* by Cass R. Sunstein and Richard H. Thaler, Fall 2003.

[4] "Survey Findings: Trends and Experience in 401(k) Plans: 2007," Hewitt Associates LLC

[5] Institutional Retirement Income Research Council survey, February 2008.

To date, the issue of how to provide a secure retirement income stream has been largely ignored.[6] Including retirement income options in DC plans is the next logical step in their evolution. Designers of these plans are now beginning to work toward identifying the best and most efficient ways to do so. Such a move represents a paradigm shift from the accumulation focus of most plans.

> Individual retirement security will become a reality for DC plan participants only if they are able to use their accumulated savings to generate lifetime income. Proactive employer-sponsored efforts to get individuals to save and invest will be for naught if they cannot do so.

Against that backdrop, the argument that employers should explore ways they can help individuals use their hard-earned savings to generate secure lifetime income becomes even more compelling. There is no longer any doubt that 401(k) and 403(b) plans and the income they generate are going to play major roles in the quality of life today's workers will have during their retirement. It follows that plan designs should evolve beyond their current focus on helping employees accumulate an adequate amount of retirement savings and expand to encourage participant behavior that accomplishes the goal of securing lifetime income during retirement.

Arguably, keeping retiring individuals in the institutional pricing and fee arena would have a positive impact on helping retirees achieve their retirement goals. Retirees would be helped further by encouragement from their employer to consider retirement income solutions that have been vetted through a strong fiduciary process.

New Options Require New Thinking

Charting this new course for the DC plan's emerging role in generating retirement income—as opposed to building retirement savings—calls for innovative, creative, and collaborative thinking.

Just as all parties involved in retirement planning under the DB model were required to alter their thinking as DC plans rose to the forefront, so too must they be prepared to embrace a new mindset as *retirement income* begins to rival *asset accumulation* in terms of importance in DC plan design.

Employers are in a unique position to help participants in the pre-retirement stage begin to think about their retirement savings in a new manner and facilitate a shift in focus from building savings to creating sustainable income in retirement. This altered view is critical to participants who face the prospect of relying on their DC assets to generate retirement income for an unknown period of time.

Given the complexity and urgency of providing secure income during retirement, the necessity of designing the best possible solutions becomes paramount. The process will not be without challenges. Among the areas affected are technology, recordkeeping, and the participant experience. Solutions must also comply with a complex mix of regulations covering retirement plans, investments, insurance, and banking.

Because there are many stakeholders involved, and the technical issues are so complex, input is required from multiple sources. The quickest, most efficient approach to developing effective solutions

[6] "The Employer's Role in Providing Retirement Income Security," PowerPoint presentation by Dr. Jeffrey R. Brown, University of Illinois and National Bureau of Economic Research.

is for retirement income solution providers, such as insurance companies and other financial services firms, to seek industry consensus on:

- The optimal features to build into retirement income solutions;
- How retirement income solutions can best be incorporated into DC plans; and
- How best to encourage appropriate levels of utilization.

Creating opportunities through DC plan design to allow retiring workers the option to generate lifetime income using institutionally priced, risk-pooling products is a logical and important next step in DC plan evolution. It should be given priority by plan sponsors and their advisers.

Why Retirement Income Solutions Should Be Added to DC Plans

There are several compelling reasons why retirement income options should be added to DC plans. We are going to explore the following in detail:

- In the current DC model, all risk and responsibility has shifted from employer to employee.
- It is becoming increasingly apparent that, left on their own, the majority of individuals will be unable to effectively manage their retirement savings to generate lifetime income.
- Recent research indicates that behavioral biases and poor financial literacy are going to hurt the average DC participant's ability to make optimal choices in creating retirement wealth and generating retirement income.
- There are several advantages to both plan sponsors and plan participants in making retirement income options available with the DC plan.
- Taking action now and adding retirement income options to DC plans may preempt mandatory changes that could be made by the government.

A notable outcome of the shift from DB plans to DC plans is a rebalancing of the amount of risk and responsibility shared between employers and employees in the retirement process. Individual employees are now shouldering more of the burden of securing their own retirement as DC plans put the onus on them to save, invest appropriately, and manage their retirement income. This is part of a broader shift toward individual self-reliance in the context of retirement planning that is also reflected in the debate over Social Security accounts, Health Savings Accounts, "cafeteria" benefits plans, and the risk of government programs to meet their promises due to underfunding.[7]

It is unlikely these same workers, left on their own, will become suddenly adept at managing their retirement savings so that it provides secure lifetime income upon retirement. Indeed, a lump-sum distribution at retirement, the most common type of DC payout, can be a recipe for disaster. So, as retirees in a DC world face the prospect of managing their nest eggs for several decades of retirement, the question of whether employers should take a more active role in assisting employees in turning their savings into retirement income looms ever larger.

By contrast, under the DB model, the bulk of financial responsibility is shouldered by the employer (plan sponsor) during both the accumulation stage and the payout stage. The employer typically hires actuarial and investment experts to efficiently

[7] Brown, op. cit.

manage risk and invest appropriately. And, the employer can spread that risk across many lives. In a traditional DC plan arrangement, the employer has been released from involvement in the payout stage. Full responsibility is transferred to the individual, who must bear his own individual risk without the benefit of pooling. This places greater emphasis on the importance of analyzing individual investor behavior. How the individual retiree reacts and invests—without the buffer of professional actuarial and investment support—will determine whether he or she will enjoy a secure retirement or outlive his or her assets.

Specifically, the risks workers confront when they retire include:

- Insufficient savings will lead some to invest too aggressively and suffer investment losses they can not sustain.
- Fear of loss will cause some to overinvest in capital preservation funds and suffer income erosion due to inflation.
- Wanting greater control or flexibility will lead some to transfer their savings out of their employer-sponsored plan and lose the advantages of institutional pricing and the protections of ERISA.
- Unrestricted access to their retirement savings will tempt some to spend down their savings on large discretionary items.
- Increasing longevity is not fully accounted for, causing them to spend down their savings too rapidly.

Each of these factors contributes to a heightened risk that retirees will outlive their assets, forcing many to subsist solely on their Social Security benefits.

The unprecedented increase in life expectancy over the last few decades has had enormous repercussions on retirement-income planning. For example, life expectancy of a 65-year-old male in the United States when Social Security was established was just over 12 years; it was 13.04 years in 1970; by 2000, it was 16.26 years; and is still climbing. Translated to a standard annuity paying one dollar a year at two percent interest, a 65-year-old male in 2000 would have needed 23 percent more wealth to finance a given stream of real retirement consumption than his counterpart in 1970.[8] In-plan income solutions address the challenges related to increased life expectancy by providing a prearranged income stream via a model familiar to participants, thus reducing the likelihood of lump-sum distributions and the dangers associated with them.

The recent economic climate, with its volatile stock market, is heightening a growing recognition among academic economists, think-tank pundits, legislators and industry experts that individuals are struggling with this responsibility. Compounding the challenge they face is the fact that new retirees often suffer from two critical handicaps: poor financial literacy and behavioral biases. A closer look at each of these issues sheds more light on why it will be difficult for the majority of individuals to self-manage their financial assets following retirement.

Poor Financial Literacy: Recent research by economists Annamaria Lusardi and Olivia Mitchell shows that most individuals lack basic financial literacy. Fully half of those surveyed could not explain the difference between a stock and a

[8] "Longevity Risk and Retirement Savings," research paper by Joao Cocco and Francisco Gomes, London Business School, January 2008; Insurance and Risk Management Dept., Wharton School of Business.

bond, and fewer than one in five could correctly compute compound interest over two years. On average, 401(k) participants in the survey rated their employer's stock as less risky than a diversified stock portfolio.[9] A lack of financial literacy can be overcome to a certain extent by getting individuals on the proper glide path to contributing and investing. Nonetheless, **poor financial literacy will severely handicap DC plan participants when they are forced to manage their nest eggs and generate lifetime income during retirement**.

Behavioral Biases: In order for the traditional DC plan construct to succeed in generating a secure retirement for employees, individual investor behavior must be close to optimal. However, **studies show that individual behavior is far from optimal**, as illustrated by the Dalbar Quantitative Analysis of Investor Behavior (QAIB). This research is a yearly analysis of investor decisions to buy, sell, and move into and out of mutual funds, and the impact of those decisions on investment performance. Dalbar's QAIB is relevant because it measures the average investment returns for individual investors, not for the funds themselves.

Based on an analysis of actual investor behavior, the 2008 report shows that the average equity fund investor would have earned an annualized return of just 4.48 percent over the 20-year period ended December 31, 2007, versus an annualized return of 11.81 percent for the S&P 500 (including reinvested dividends) over the same period. In other words, left to their own devices, individual investors would have underperformed the popular stock market index by more than half. Fixed-income investors fared even worse, earning 1.55 percent annually over this period, compared to the Lehman Aggregate Index return of 7.56 percent. **The report concludes that "Investment return is far more dependent on investor behavior than fund performance."**[10] **The evidence indicates that individuals struggle with asset allocation over the long-term**.

The Dalbar report on investor behavior is particularly significant since it applies to mutual funds, the investment vehicle into which the majority of DC plan participants currently roll their lump-sum payouts. In the above scenario, with a typical retiree investing in a 50/50 portfolio of stock and bond funds, that individual stands to capture only 30 percent of market returns during 20 years of retirement. Numbers like those strongly support the argument that **the current DC plan construct, with its focus on a lump-sum distribution at retirement, represents a recipe for failure for the typical DC retiree who is trying to generate sufficient retirement income through mutual funds alone**. It is probable that this conclusion would just as likely apply if the retiree were investing in individual stocks and bonds, and not mutual funds.

Just as individual investors in mutual funds are vulnerable to periods of increased buying and selling after steep market dips, so too is the phenomenon evident among participants in 401(k) accounts. As the S&P 500 index dropped over 40 percent from its October 2007 high, retirement savers tracked in the Hewitt 401(k) Index™ moved $4.9 billion dollars out of 401(k) equity accounts and into fixed-income accounts on a net basis during the first three quarters of 2008."[11]

Despite the gap in secured retirement income that has emerged in the wake of the shift from DB plans to DC plans, few 401(k) plans currently provide their participants with an easy way to correct that

[9] "Financial Literacy and Retirement Planning: New Evidence from the Rand American Life Panel," by Annamaria Lusardi and Olivia Mitchell, University of Michigan Retirement Research Center working paper WP 2007-157.

[10] Dalbar Quantitative Analysis of Investor Behavior, 2008.

[11] The Hewitt 401(k) Index™ Observations, June 2008 and September 2008.

shortfall. Only 15 percent of employers with 401(k) plans surveyed in 2007 offered participants a single-premium immediate annuity as a distribution option at retirement.[12] However, simply increasing the number of plans offering annuities at the time of distribution is not the whole answer. **Plan participants have consistently demonstrated a behavioral bias against choosing longevity protection via an immediate annuity**. Just three percent of retirees who were offered that option chose to take it in 2007.[13]

Although little formal research has been completed on how individuals are managing their 401(k) wealth in retirement, there is abundant and growing anecdotal evidence that suggests many are headed for trouble due to their poor investor behavior and their unwillingness to purchase annuities upon retirement.

Significant Advantages of Offering Retirement Income Solutions to Both DC Plan Participants and DC Plan Sponsors

The IRIRC believes that there are significant advantages to both plan participants and plan sponsors in using DC-housed retirement income vehicles.

Advantages for participants of a DC plan that makes retirement income solutions available include:

- Lower fees, resulting in higher retirement lifetime income;
- Access to risk-mitigation strategies that can significantly lower the cost of retirement compared to self-insuring; and
- Employees will likely have a significantly enhanced probability of lifetime security if offered the ability to generate income from institutionally-priced retirement income solutions.

And, if the solution is an in-plan arrangement:

- Purchases over time, resulting in less behavioral resistance and the ability to realize the benefits of dollar-cost averaging;
- Income guarantees that can help to mitigate investment risk and encourage long-term investment of other assets in equities; and
- Ability to "test drive" a product, often with few or no penalties if they change their mind prior to retirement.

But what advantage is there to employers that reposition their DC plans as retirement plans, and not simply *savings* plans?

In addition to being in a unique position to have a significant positive impact on the future retirement of their employees, plan sponsors should be motivated by the following:

- Assets of retirees can be maintained in the plan, lowering costs for all participants due to economies of scale.
- Employees who are less worried about their finances are more productive.[14]
- Team productivity and morale is threatened when individual employees work beyond their appropriate retirement because they can not afford to retire.

[12] Hewitt Associates, op. cit.

[13] Hewitt Associates, op. cit.

[14] "American Workers: Getting Ahead or Just Getting By?," by Tom Kane, Alliant Credit Union, August 2008.

- Providing a comfortable segue into retirement for workers allows opportunity for advancement by others.
- Employment costs and succession planning can be better managed if retirement is financially feasible for older workers.
- Reputational risk to the employer is lessened if employees are able to retire with dignity.
- The value and competitiveness of the retirement benefit can be improved with only minimal increased costs that are associated with implementation, communication, and monitoring.

Taking Action Now May Preempt Government Intervention

Legislators in Washington are concerned about the financial security of the nation's retirees, especially as DC plans become the main source of retirement income other than Social Security for a growing number of people. While many individuals retiring with DC wealth today also have DB pension income, this will not be the case going forward. The traditional "three-legged stool" of Social Security, a DB pension, and personal savings will be short one leg for the majority of future retirees.

Most of today's DC plans launch retirees into their retirement years with a lump-sum payout and best wishes for the future. As the bear market in stocks in 2007-2008 has hit retired and near-retired investors hard, there are increasing and legitimate concerns regarding retirees' inability to manage their nest eggs.

If retirement income solutions are not embraced within the DC plan construct, it is very likely that Congress will order changes that it believes will boost the financial security of a nation of DC retirees. Those solutions could include:

- Expansion of Social Security-type benefits, which would increase payroll costs, reduce plan sponsor control, and erode the employer's ability to use retirement benefits to attract and retain talent (Note: benefits outrank compensation as the reason employees stay with their current employer.[15])
- Additional investment structure and investment option requirements, increasing the burden of fiduciary oversight.
- Changes to investment defaults, causing disruption and confusion to all.
- Mandates intended to increase savings levels, raising the overall costs associated with maintaining the DC plan.
- Restricted participant choice, reducing participants' ability to manage their retirement to their specific situation.
- More complicated plan design requirements, increasing communication and administrative burdens and heightening the risk of non-compliance.

The IRIRC believes that plan flexibility and choice is worth maintaining for both employers and their employees, and that additional governmental mandates, while well-intentioned, can have significant detrimental impacts.

[15] "Benefits: Adult Education—By Helping Employees Make the Most of the Benefits Companies Offer, Employers Help Themselves as Well," by Josh Hyatt, *CFO Magazine*, October 2008.

Conclusions

We need to give employees options *within their 401(k) and 403(b) plans* to generate secure lifetime retirement income. We need to create better outcomes in terms of retirement income for participants before change is forced upon us.

When we help to make the DC plan a true retirement plan, both plan sponsors and plan participants will benefit. These evolutionary changes will not come about without some effort. All stakeholders should participate in the discussion to allow the industry to more quickly develop consensus and implement the most optimal array of solutions.

The IRIRC believes this is an urgent issue facing our industry and the future of retirees. The IRIRC intends to contribute to that discussion over the near term and provide insights and tools from which all in the industry may benefit. Stakeholders in the industry are encouraged to take part through the following recommendations:

- Create a sense of urgency to participate and be vocal in the dialogue on the need to consider inclusion of income solutions in defined contribution retirement plans, and involve as many stakeholder groups as possible in those discussions.
- Work with other stakeholders to drive to a consensus-driven—rather than a product- and market- focused—standardized approach to creating, evaluating, implementing, and monitoring retirement income solutions.
- Focus on solutions that address the problems of behavioral biases and limited financial literacy among many plan participants.
- Acknowledge the need to initiate this process quickly; otherwise, plan providers risk having government-mandated solutions imposed on them.

Working together and creating the right dialogue can contribute to an outcome of improved lifetime DC financial security for employees—the ultimate goal for all stakeholders in this discussion.

"The future of 401(k) plans has begun. Attentive plan sponsors and fiduciaries will want to embrace these changes to show their compassion for their employees and to help those employees achieve retirement security."

Fred Reish, nationally recognized expert in employee benefit law, in *PLANSPONSOR* magazine, July 2008.

Our Next White Paper

Understanding and differentiating the new generation of DC retirement income options now available in the marketplace.

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