

## **Expanding solutions for retirement income management Risks, Barriers and Dreams**

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As we focus on successful organization of the retirement income 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 plans, this was not 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, so voluntary annuitization has become much more important. This article will deal with the risks facing retirees, some of the challenges and barriers to the use of life income, and then conclude with some “dreams” that might make life income more of a reality in the future.

### **Risks**

There are several risks that retirees are subject to. Exhibit I was developed by the Society of Actuaries in conjunction with the 2005 Risks and Process of Retirement Survey. The survey provides information about how retirees view these risks and what is most important to them. This survey and focus groups conducted by the Society of Actuaries in 2005 indicate that there is considerable misinformation about risks and that in addition to the misinformation, many people do not think long term, even when planning for retirement. The focus groups were titled “Spending and Investing in Retirement: Is There a Strategy” and the report can be found at ([www.soa.org/ccm/content/areas-of-practice/retirement-pension/research/spending-and-investing-in-retirement--is-these-a-strategy/](http://www.soa.org/ccm/content/areas-of-practice/retirement-pension/research/spending-and-investing-in-retirement--is-these-a-strategy/)). The reports from the risk survey can be found at ([www.soa.org/ccm/content/areas-of-practice/special-interest-sections/pension/research-thinking-ahead/post-retirement/](http://www.soa.org/ccm/content/areas-of-practice/special-interest-sections/pension/research-thinking-ahead/post-retirement/)). (Note that there are five separate reports—a full report on the survey and four reports that focus on specific portions of the results.)

**Exhibit I**  
**Risks Facing Retirees and Comments about Their Management**

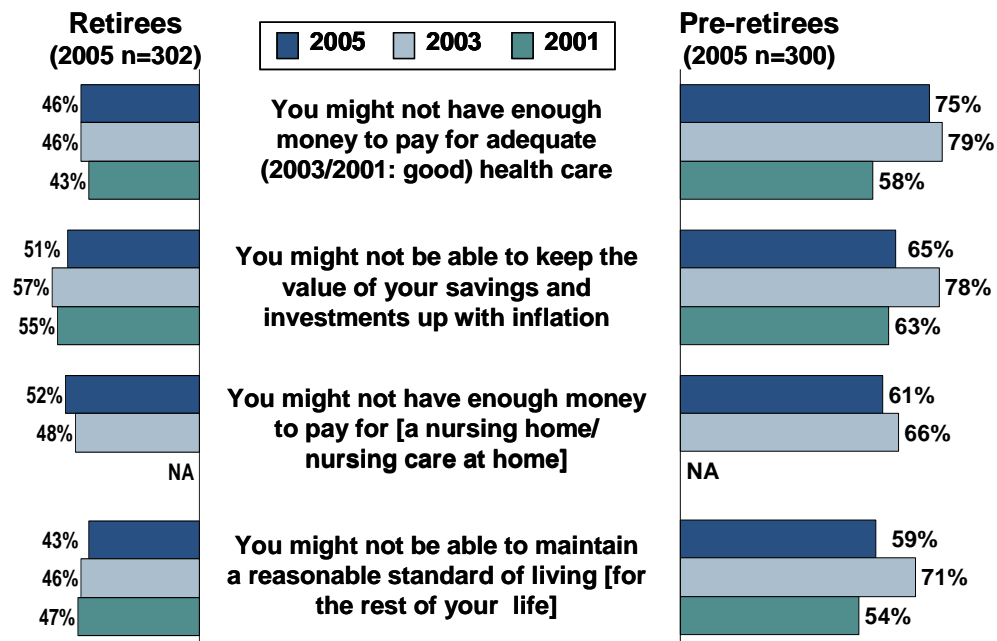
<b>Risk</b>	<b>Products for Risk Transfer and Potential for Pooling</b>	<b>Comments</b>
Outliving assets	<p>Annuities, including joint and survivor annuities and deferred annuities commencing at higher ages such as 85 (longevity insurance)</p> <p>DB plans often automatically provide life income</p> <p>Risk transfer not needed if investment income without using assets exceeds expenses</p> <p>A few inflation adjusted annuities are available, and annuities without inflation adjustment provide only partial protection.</p>	<p>Consideration of both spouses is needed in designing a strategy.</p> <p>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)</p> <p>Bond ladders offer other strategies to produce long-term income, but not income guaranteed for life</p>
Loss of spouse	<p>Joint and survivor life annuities, life insurance</p> <p>Long-term care insurance helps protect assets that may be left to spouse</p>	<p>For women, periods of widowhood of 15 years and more are not uncommon</p>
Cost of disability and long-term care	<p>Long-term care insurance</p> <p>Continuing care retirement communities</p> <p>Medicaid pays for cost for many people without assets or income.</p>	<p>Nursing home costs can exceed \$70,000 per year today.</p> <p>Care can be provided at home, in an assisted living facility, adult day care center, or nursing home</p>
Cost of acute health care	<p>Medicare</p> <p>Medicare supplemental insurance including employer-sponsored retiree health benefits</p>	
Investment risk, inflation and interest rate risk	<p>Investment strategies can reduce risk; some products provide minimum guarantees</p> <p>Inflation protected bonds</p> <p>Annuity products with cost of living adjustments</p>	
Inability to find job, loss of job	<p>No way to pool on a longer term basis</p>	
Family members needing care	<p>No way to pool</p>	

Several of the risks shown in Exhibit I can be pooled and transferred, except for inflation risk. 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% of Americans end up retiring before they had expected to, often because of job loss, poor health or family issues.

Exhibit II tells us about the major concerns of retirees and pre-retirees in the 2005, 2003 and 2001 Society of Actuaries Risks and Process of Retirement Surveys.

Exhibit II

How concerned are you that . . . ? (percentage very or somewhat concerned)



Source: Society of Actuaries, 2001,2003 and 2005 Risks and Process of Retirement Surveys

Some key points to be aware of as we review Table II:

- Pre-retirees are much more concerned about risk than the retirees
- There has been little change in the retiree perceptions about risk over the three years
- Pre-retiree became more concerned between 2001 and 2003, not surprising in light of the terrorist attack in New York and the poor equity markets, but they have reduced their concern from 2003 to 2005
- Medical costs is the biggest risk concern
- Outliving assets is not a big issue

Investment knowledge:

Studies of knowledge about investments also show misunderstanding. From their responses to basic questions as to how investment vehicles work, the public appears poorly prepared to assume the management of retirement assets.

A useful perspective of the public's knowledge of investments can be found in the John Hancock Life Insurance Company's 2004 study in the series, *The Insight into Participant Investment Knowledge and Behavior Study*. This is the 9<sup>th</sup> in a series of surveys that started in 1992. Respondents to that survey all participated in 401(k) or similar plans that gave them investment choice, so all have some exposure to investments, but many show significant gaps in their knowledge of investments, and confusion about how investment vehicles work, their relative risk and what they include. Survey respondents were unclear about the features and risk profiles of many investment vehicles common to employer-sponsored plans.

For example, participants were confused about the relative risk of company stock. When asked to rank the risk of various investment options within their employer-sponsored plans, in all nine surveys, respondents ranked their company's stock as less risky than diversified domestic stock funds or diversified global stock funds. Unfortunately, familiarity with the employer, combined with the loyalty of the employee may lull the participant into a false sense of security regarding employer stock as an investment. The 2004 survey results did not seem to be influenced by widely reported corporate scandals at Enron and other firms that led to bankruptcies or many losses in stock values in recent years.

As another example, the participants did not understand what a money market fund is. When asked what types of instruments are found in a money market fund and allowed multiple responses, 48% said short-term investments, 47% said bonds, and 43% said stocks. Only 9% knew that money market funds contain only short-term investments.

In addition, most participants do not understand how bonds perform in changing investment markets. Specifically, they do not understand that the market value of a bond moves inversely with changes in external interest rates. In the Hancock's 2004 survey, more than three-quarters, 77% of respondents, did not know that the best time to invest in bonds is prior to a decrease in interest rates.

Over time, the level of misunderstanding has been consistent since these questions were first posed in 1992. Since all respondents to these surveys were required to participate in their employer-sponsored defined contribution plan, and therefore had some investment experience, the average American is probably even less well educated than suggested by the results to this series of surveys.

### **Stakeholders in retirement benefit delivery**

Several groups of stakeholders interact within the delivery system producing retirement income. The stakeholders are (1) the public who can also be thought of as employees, (2) employers who sponsor plans and access to group purchase of products, (3) financial service companies and other providers, (4) advisors and (5) regulators. These groups interact and influence each other. As we think about barriers, we will focus on each of these stakeholder groups.

### **Barriers to Retirement Income Delivery**

## The Individual Perspective

The barriers to retirement income vs. 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 are needed. Lack of flexibility once an annuity is purchased is a major issue and barrier to purchase. It leads to the need to think about how much of the portfolio might be used to buy annuity income. The entire portfolio should not be annuitized.

As we think about how individuals think about risk, there are some key findings in the research:

- 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 not based on sophisticated analysis, and sometimes not on any quantitative analysis
- Reducing spending is the most popular risk reduction strategy
- Control of assets is an important issue, but at the same time many people are not able to exercise the control well

The population can be divided into segments by resource level:

- At the lower end are people with little in the way of financial assets and income beyond social security – purchasing guaranteed income is not an option for them
- At the high end are people who have investment income that more than covers their regular expenses. They do not need to purchase guaranteed income.
- It is the group in the middle we are concerned about.

The discussion of risks above 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 provide perspectives on how individuals view retirement issues and what the barriers are from that perspective. Some key points from the focus groups that looked at how retirees with significant 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 take 6% of assets and compare to expenses (less income from other sources) and use this as a measure of affordability of retirement.
- 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 2005 Risks and Process of Retirement Survey can be found at [www.soa.org](http://www.soa.org)

### **The perspective of the insurer and financial services company**

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 agents to sell them, and risks relating to the financial structure of the products and their guarantees.

Generally, immediate annuities are not very attractive to most agents. The commissions are often not very high and selling them requires specialized knowledge. This is overcome through the use of specialist wholesalers who offer a lot of product knowledge and support the individual agent. In addition, there is an issue of target market and matching the needs for annuity products. For many agents the middle market is not the most attractive place to be, because sales (and therefore commissions) are not large enough. Finding a viable method of marketing with a cost that is acceptable to the seller and the buyer is a key issue. An important step in this direction will be building a culture that focuses on the importance of the distribution period.

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 really protect life income, 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, 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 anti-selection and change the risk pool. This is discussed further in the paper by Mark Warshawsky. 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 today include combination products, longevity insurance, new coverages, reverse mortgages and others. As with other financial products, tax structures as well as need drive the product structures. The minimum distribution rules were cited as one of the barriers to product innovations.

There is also a need for better planning for risks, and new approaches to planning would support better approaches to income.

### **The Employer Perspective**

The next stakeholder to consider is the employer. Traditionally employers offer income through defined benefit plans, and there are no special problems to focus on. However, most defined contribution plans offer lump sums and not life income and as these plans are growing, it is important to consider issues surrounding life income in defined contribution plans. These plans have evolved, are more often the primary retirement vehicle and since 2002, there has been a growing focus on results produced by these plans. For instance, default options are now recognized as critically important, since 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.

The distribution of benefits and making funds last during retirement are important issues in achieving success and meeting plan goals. Plan sponsors are reluctant to offer annuity options directly because of spousal consent requirements, “safest annuity rule issues,” and/or fiduciary responsibilities, etc. Instead, companies such as IBM are beginning to offer annuity options outside of the plan but with institutional pricing through a third-party IRA rollover program. Under the third party program, the annuity can be purchased at retirement or later, and in steps over time. Note that the Pension Protection Act opens the way to an easing of the safest annuity rule issues.

Satisfactory results post-retirement will depend on having good methods for providing advice 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.

### **Regulatory Issues**

Several regulatory issues relating to employers and use of income options in defined contribution plans are mentioned above. However, the intersection of regulations affecting the insurer and plan sponsor must also be considered. When the regulatory issues facing all of the stakeholders are merged, the total impact of the regulations is overwhelming. Two more issues that should be mentioned include conflict with regard to uni-sex rates and issues surrounding minimum distribution rules. Employer plans are not permitted to use sex based rates, whereas virtually all annuity contracts are priced using sex based rates. The minimum distribution rules require that qualified plan funds be distributed beginning after age 70½. Their structure creates complexity for purchasing annuities overtime on a staggered basis and for combination products that put annuity and long-term care into the same insurance product. Both annuities and long-term care are heavily regulated but by different rules, and the regulations make it hard to combine them. Provisions of the Pension Protection Act open the way to combination products in the future.

While employers often chose defined contribution plans as a way to escape from extensive defined benefit plan regulation, defined contribution plans also have extensive rules. One of the results of these rules is that employers do not provide more opportunities for the use of retirement assets to provide regular lifetime income. The more active an employer is in addressing post-retirement issues, the more rules apply.

## **I have a dream**

Based on my ideas and discussion with colleagues, here are some ideas for improving the situation with income management approaches. We should:

Unify and rationalize the regulatory environment—with pensions regulated by the IRS, DOL, PBGC, FASB and sometimes the SEC, and annuities regulated by state insurance departments and sometime the SEC, there is a huge mass of complicated regulations. In addition to regulating the employer and the financial services company, income tax rules impact when it is attractive to use a risk protection product and when not. They complicate what would otherwise be rational strategies. Unified and balanced regulation would be important to opening the way for simple and logical solutions.

Default distribution options in a 401(k) plan -- today lump sums are the common default, and life income options are often not available. I would prefer to see a default distribution that leaves the money in the plan to 70 and provides for paying out 4 percent per year as regular installments. At age 70 and for each of the next four years, annuitize 10 percent of the balance on a 100 percent joint and survivor basis. The retiree would be able to opt-out of this default option for any funds not yet annuitized. The advantages of this option include:

- Giving participant time to think irrevocable decisions
- Forcing individual to consider an annuity
- Dollar cost averaging
- Thinking about matter from portfolio point of view

Implement a tiered flexible account product that would allow annuitization in steps of all or part of the retirement assets. Annuitization in steps is a means of dollar cost averaging and offers a route to inflation protection. This account would also allow for regular monthly installment withdrawals and one time withdrawals to meet special needs. A variation on this is to provide a laddered plan with different buckets. The first bucket might be used to provide income for the first five years.

Consider product innovations ---Ideas for innovations include:

- Combination annuity and long-term care product offerings: From the point of view of managing risks, it would be ideal to combine various product offerings, or offer them as a holistic package. As such, they could be priced more effectively and would help people manage multiple risks through a single product purchase.

- Offer special annuity products for people in poor health. This would be another way to capitalize on risk characteristics.(Note: there are several companies that currently offer substandard annuities.)
- Longevity insurance: This is a deferred annuity (without cash values or death benefits on early death) that pays benefits starting at a high age such as 85.
- Further development of reverse mortgages and other programs to use housing wealth. Evaluate these alternatives and compare to other options to provide guidance to help people understand when they are most likely to be effective.
- Unbundle retirement annuities would be a clearer way to think of the product, parallel to universal life. Universal life unbundles life insurance by separating out the accumulation amount and the cost of mortality. An annuity can be unbundled by setting up as an accumulation account, and added a “dividend” to reflect the value of survivorship. That is, the amount of accumulation for those who die is redistributed to those who continue as participants. This helps open the way to other innovations.

Risk protection riders can be made available with either a withdrawal account and with regular annuity purchases to provide for medical benefits and long-term coverage. Other options could be offered such as critical illness insurance.

Recognize the employer as the ideal way to reach the middle market—the market needs to be segmented and it is very difficult to reach the middle market through one-on-one interactions with financial professionals. The workplace is the best route to reach this market, and the employer who offers advice needs to be protected. At the same time, there are a variety of legal and fiduciary requirements that make it challenging and risky for the employer to offer advice and income in retirement to participants in defined contribution plans. Policymakers and regulators should revisit these requirements to give employers more certainty regarding regulatory parameters of what they can do, in light of the need to involve the employer more in retirement income planning. When such certainty is achieved, the employer segment has a much greater potential for meeting the needs of the middle market.