Concerns about Participant Interest in Retirement Income Solutions

Volume 2, Number 1

The responses to the recent Request for Information by the DOL and Treasury and subsequent hearings to discuss lifetime income options for DC participants has sparked a national dialogue on whether these options belong in defined contribution plans. One argument against introducing lifetime income via the DC plan is the lack of participant demand. On first glance, this might be a valid argument. But on deeper inspection, it is apparent that workers appreciate the benefits of a secure income during retirement, and lack of demand is a direct result of how insurance-based retirement income has been framed for workers when they are faced with making decisions about annuitizing.

The "Annuity Puzzle"

The "annuity puzzle" is the generally held view that when participants are asked what they desire foremost from their retirement nest egg, what they describe is an annuity. And yet insurance-based retirement income solutions have a history of very low participant use. Why does this dichotomy exist and is it real?

On the surface it appears that there is little interest in insured retirement income solutions. [i] This holds true whether looking at the data for those who are faced with the decision to annuitize their retirement account upon retirement, as well for those who have the option of investing in a guaranteed income option embedded within a defined contribution plan during the accumulation stage.

Surveys abound that document findings similar to Fidelity's March 2009 survey, where 97% of the public, age 55 to 70, believe it is critical to protect their assets against volatility in order to provide them an income during retirement[ii]. Even more compelling, the Allianz "Reclaiming the Future" study conducted in May 2010, found 61% of respondents feared outliving their assets more than they feared death[iii]. But paradoxically, just as frequently these same surveys find that when the solution is explained using the word "annuity" there is a dramatic decrease in interest.[iv]

Why is there such a visceral reaction to the word "annuity"? Traditional explanations abound, including the public lacks a good understanding of annuities, or that the public equates an annuity with loss of control, loss of liquidity, and an inability to leave a legacy to their beneficiary. Another traditional explanation is that they have a mistrust of insurance, that if it is an annuity, it must be complicated and expensive, with lots of fine print.

Leveraging Behavioral Economics into Retirement Decisions

But new research suggests that the answer lies in the way retirement income products have been marketed to participants. Perhaps it is a myth that participants do not desire solutions that:

- protect their principal and/or future income in volatile markets,
- provide peace of mind to equity exposure,
- control risk, including the risk of outliving assets, and
- keep up with inflation.

In fact, not only do they desire such features, they overwhelmingly choose to insure their accounts if framed in terms of spending, according to a behavioral finance study released by Jeffrey Brown, Jeffrey Kling, Sendhi Mullainathan, and Marian Wrobel.[v] Dr. Brown and his colleagues found that if annuities are framed in a consumption view (e.g. the amount of spending that would be supported) and not as an investment view (e.g. focusing on risk and return characteristics), the public would believe them to be a superior vehicle as they offer valued insurance.

The researchers asked more than 1,300 individuals age 50 and older their preference between two options with identical actuarial values (e.g. economic value). One option was a life annuity paying $650 each month until death, and the other was a traditional savings account of $100,000 bearing 4% interest. When individuals were asked if they would choose the annuity when it was described as providing income for life, there was tremendous interest, with 72% selecting the annuity over the interest-bearing account. By contrast, when asking participants if they would choose the annuity when it was described as an investment with a return of $650 for life, only 21% selected the annuity.[vi]

Reinforcing Dr. Brown et al.'s conclusions, the Allianz "Reclaiming the Future" study found respondents overwhelming preferred an option that emphasized guarantees over high returns. When asked to choose between high returns or guarantees, 69% said they preferred a product that was guaranteed not to lose value, while only 31% preferred a product whose goal was high returns. 80% of the people surveyed preferred a product with a 4% return that guaranteed no loss of value over a product with an 8% return and vulnerability to market downturns.[vii]

> *"But new research suggests that the answer lies in the way retirement income products have been marketed to participants."*

The Shifting Focus of DC Plans

Consider the history of retirement plans and the way many participants have experienced their introduction to saving for retirement. Not long ago participants identified their 401(k) as a voluntary supplemental savings plan, money that could be invested in a tax-favored program and given to them as a "lump sum" when they retire. They may have been encouraged to save by the addition of a company match. And if they needed the money before retirement, they could access it as a loan or hardship distribution. 401(k)'s were first and foremost a savings plan.

The communication and education that wrapped around these savings plans focused on the accumulation of a pool of money, providing generic education on how to select investments from the plan's menu of options. Participants counted on their pension plan and Social Security to provide retirement income while their 401(k) was for "the extras".

Retirement conversations were about what one planned to do in retirement. Plan communications tended to focus on "connecting the money to the emotion" to get employees to save more for retirement. But the materials avoided the complex and sobering reality of what would be involved to manage their savings after they retired.

As defined contribution plans began replacing defined benefit plans, participants began to by wrestle with this responsibility by first asking "Will I have enough?", which in turn lead to "How much is enough?". But the answers to these questions continued to be in terms of a lump sum. For example, if a participant wanted to replace 80% of their pre-retirement income, would they need to accumulate 10 times their annual pre-retirement pay? 15 times? 20 times?

Employers, happy to be relieved of the burden and volatility of the defined benefit plan, went to the other extreme and took the position that their responsibility ended with making contributions to the plan and providing a reasonable selection of investments during an employee's working years. What happened after employment ended was not their responsibility. There was no focus about how to generate income in retirement. Retirees were on their own.

But as defined contribution plans became the primary company-sponsored retirement program, the short-comings of the defined contribution plan has gained attention. In his keynote address at the Pensions & Investments Defined Contribution Conference October 2010, Robert C. Merton, a professor with the MIT Sloan School of Management and a past Nobel prize winner in economics, emphasized that shifting the investment decisions to participants, few of whom are equipped to handle complex financial management issues, makes the defined contribution plan unworkable as a core retirement solution.[viii] He made a compelling case against the current focus on investment returns and risks, and used as an example the odd outcome of requiring plans to report fluctuations in *market values* of insured investment vehicles when the *level of benefit* being provided has not changed. Instead, he argued, the emphasis should be on units of future retirement income, similar to Social Security and traditional defined benefit plans.

How Traditional Framing Has Failed

Traditionally, quarterly benefit statements emphasize short term valuations, e.g. what the account value is this quarter and year-to-date activity. They show the recent relative performance of the various investment options with no focus on income in retirement. Compare this to how a participant sees their Social Security statement, which shows a monthly income projection at retirement along with how much they contributed to achieve this expected income.

Low incidence of annuitization upon retirement is often cited as evidence of the lack of demand for annuities. But consider the way annuities have been presented to many participants. At the time of retirement a participant is presented with a description of the available forms of distribution. The most common form is a single, large, and simple-to-explain-simple-to-understand lump sum. Some plans may offer installment payments, where the participant can choose to keep their account in the plan and receive a portion of the account over a specified period of time. If an annuity is offered, participants are presented with a multi-page brochure with a dizzying array of options, a print out with the calculation of low monthly income figures (and an even lower monthly income if including a spouse). Before a participant can select an annuity, they must first:

"Low incidence of annuitization upon retirement is often cited as evidence of the lack of demand for annuities. But consider the way annuities have been presented to many participants."

- understand all the technical terminology such as joint and survivor, certain and life, etc;
- have confidence in the ability of the insurer to pay the benefit over a long period of time;
- assess their own health and take a guess as to whether they will live longer than the actuarial odds;
- if married, decide if their spouse can "make do" with less if they die first;
- understand a lot of the small print;
- accept that they cannot protect this income from inflation unless they agree to an even smaller monthly payment; and
- get comfortable with handing over their nest egg to an insurance company with whom they likely have no previous experience --- in fact, it is probable that the people they are used to speaking with about their retirement account are precluded from speaking with them about the insurance product because of state licensing requirements.

And yet through all of this no one has spoken to them in terms of what is required to manage their account balance to meet their income needs if they elect the lump sum or periodic payments. No "fine print" is required to be provided for these options, just a simple reminder to "consult your tax or investment advisor".

Participants are not presented with:

- the complex issues associated with managing and controlling a pool of money to generate income;
- how their retirement income will be affected if there is a market downturn;
- the higher costs of managing their nest egg in a retail environment; or
- how there is a 50% chance they will live longer than the average.

> *"And yet through all of this no one has spoken to them in terms of what is required to manage their account balance to meet their income needs if they elect the lump sum or periodic payments."*

And, with no prodding, participants are unlikely to face the prospect of how they will manage their money as they become more feeble and vulnerable in their 80's and 90's. All of the difficult issues associated with the lump sum or periodic payment options are effectively avoided.

When framed in the traditional way --- a simple lump sum versus the daunting issues that MUST be considered to take an annuity --- it is not surprising that only 1% of participants who have the option of annuitizing their defined contribution account balance elect to do so.[ix]

Improving Retirement Outcomes by Re-framing DC Plans

Participants' interest in income solutions is increasing as a result of:

- recent market volatility;
- the changing landscape of retirement savings, with defined contribution plans replacing defined benefit plans;
- the creation of new retirement income products;
- the growing awareness of the challenges of managing a nest egg, especially for the "old-old"; and
- the grave concern retirees have about outliving their money.

Several trends are emerging, being led by employers who ***do care*** about improving the retirement outcomes for their workers, employers ***who are*** concerned with more than simply providing a competitive contribution and a choice of investments.

- Employers are becoming more involved with putting their workers on the right track toward retirement, as evidenced by the implementation of automatic enrollment and automatic deferral increases, and establishment of default investment options (which many employees interpret as an investment recommendation).
- Participants are being offered tools to help them answer questions such as "How much is enough?", "Will I have enough?", and "How will I get there?"
- Retirement plan statements are beginning to look more like Social Security statements, refocusing participants on their income replacement value.
- Education is framing the retirement saving conversations as a need to replace current earned income, not just as a means to building an investment account.
- Employers are offering pre-retirement seminars to help workers anticipate and prepare for the myriad of issues facing near-retirees, including the challenges of managing their nest egg.

In this context, income solutions are seen by participants as providing the valued security of a predictable income stream and relief that they no longer need to be "investment gurus". They can be less concerned with monitoring every market downturn or negative economic report.

In addition, with the newer generation products such as guaranteed minimum withdrawal benefits, participants appreciate the peace of mind of having a known floor of retirement income. They see these new retirement solutions as the key to permit their investment strategy to be more heavily weighted in equities, giving them an opportunity to protect against inflation during their retirement years. They appreciate that they do not have to lose total control of their assets while annuitizing in many of these solutions.

> "All of the difficult issues associated with the lump sum or periodic payment options are effectively avoided."

Conclusion

By shifting the focus of defined contribution plans from savings plans to plans that provide retirement income, America's workers will be better able to manage their retirement years.

As Dr. Brown et al. validated, participants overwhelming choose insured retirement income solutions --- by a 3-1 margin --- when correctly framed. They have a very strong desire to know what income level they can depend on when they retire. Participants understand a retirement income solution is a tool to reduce risk in a volatile market, a way to sustain their income over their lifetime. And it is an effective approach to address their fears of outliving their assets.

A tsunami of demand is building. Employers who strive to be the "employer of choice" and providers who want to grow their business will recognize this and take proactive steps to be in front of the wave.

Endnotes:

[i] According to Hewitt research, only 1% of those being offered the opportunity actually annuitize their 401(k) balance. "The Survey Findings: Trends and Experience in 401(k) Plans", Hewitt Associates 2009.
[ii] "Customer Panel Survey" Fidelity Consulting Group, March 2009.
[iii] "Reclaiming the Future: Challenging Retirement Income Perceptions", Allianz Life Insurance Co, 2010.
[iv] Ibid.
[v] "Why Don't People Insure Late-Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle", Jeffrey Brown, Jeffrey Kling, Sendhil Mullainathan, and Marian Wrobel, 2008.
[vi] Ibid.
[vii] Allianz page 12.
[viii] Merton, October 25, 2010.
[ix] Hewitt, page 68.

Institutional Retirement Income Council (IRIC)

As the burden of funding retirement has shifted from employer to employee, defined contribution plans, such as 401(k)s, have become the primary source of retirement savings for an increasing number of Americans. Yet DC plans were originally designed as supplemental retirement savings vehicles and were generally never intended to provide guaranteed lifetime income.

The mission of the Institutional Retirement Income Council (IRIC®) is to facilitate the culture shift of defined contribution plans from supplemental savings programs to programs that provide retirement security. By providing a forum for insightful, solutions-oriented thought leadership on institutional retirement income, IRIC is promoting the need for retirement income adequacy for defined contribution plan participants.

A membership-based organization, IRIC is supported by sponsors, and a panel of industry advisors, who are dedicated to sharing best practices, informing about legislative and regulatory issues and facilitating solutions for plan sponsors and their participants.

Contributing Writer:

Dorann Cafaro
Founding Partner, Cafaro Greenleaf

Dorann is the founding partner of Cafaro Greenleaf, started in 1981. She also is among the founders of National Retirement Partners, a leading national network of independent retirement experts. PLANSPONSOR magazine recently named Dorann their Retirement Advisor of the Year. She was named by 401k Wire as one of the 50 most influential people in the 401k retirement industry, and is a frequent and keynote speaker on the retirement industry at national conferences and seminars.

Cafaro Greenleaf provides retirement consulting services to retirement plan sponsors and their participants. They focus exclusively on design and implementation of retirement plans, providing the identification and monitoring of investment programs tailored to meet plan sponsor's needs. Cafaro Greenleaf is focused on addressing liabilities, minimizing costs and reducing the burden on the benefit providers. In addition, they deliver in-person education around the country.

Dorann has been a Regional Director of Retirement Services for Prudential Investments, a Corporate V.P. and National Director of Retirement Planning for PaineWebber, and a Senior Vice President of Marketing for a leading money management firm. She holds a B.S. from Marquette University in mathematics, and is Series 7, 8, 63, 65 and Health and Life licensed. Dorann frequently lectures at national conferences on retirement planning and has provided retirement education and consulting services for Fortune 500 companies. Dorann, with over 28 years in the financial industry, is recognized for her unique, unbiased consulting advice.