

**Individual comments on
Income options for beneficiaries in retirement plans
from topics discussed at the recent Society of Actuaries conference --
20/20 New Designs for a New Century**

June 3, 2010

Introduction:

While there were a number of applicable topics discussed at the just completed Society of Actuaries conference considering the merits of various changes to current benefit plan arrangements (the “Conference”), four stand out as potentially being most relevant to the issue of income options for beneficiaries in retirement plans – particularly beneficiaries in Defined Contribution (DC) plans – about which the Department of Labor has recently inquired.

The first two make greater use of the existing Qualified Default Investment Alternative (QDIA) regulatory base. One potentially addresses the financial literacy impediments many current DC plan participants face that currently constrain their ability to fully realize the post retirement income potential of contributions they and their employers make. The second addresses a potential way to increase both overall access to and take-up rates on existing DC Plans beyond the respective 61% and 70% rates that had already been achieved, as reported in the Department of Labor’s most recent report on Employee Benefits in the United States (March 2009).

The third relates to the benefits of adding some form of standardized calculations about potential benefit levels at retirement to current DC plan reporting. The Social Security system has incorporated such standardized calculations in their reports and some suggested additions to DC plan reporting may also remedy this observed shortcoming.

The fourth relates to a discussion of the merits of creating a related set of regulations to the existing QDIA regulations that might usefully help to guide core best practices for lifetime income alternatives for the income phase. Such standards would be able to equally apply for combined solutions that wanted to serve both phases. Much like the QDIA standards have, such related regulations would not preclude other alternatives from being offered. Rather, they would just help to differentiate core ones, particularly for plan participants and retirees who lack the financial literacy to fully evaluate all of the possible alternatives that might be available to them when they are seeking to turn their accumulated assets into retirement phase income.

All of the above four observations have the additional merits of requiring potentially only minor modifications or extensions of existing regulatory and institutional frameworks.

Comment 1: Addressing the implications of low financial literacy levels of DC plan participants

One observation that has received increasing recent attention is about the opposing influences of (i) the ongoing requirement that DC plans offer sufficient choice to their participants while at the same time (ii) providing for and sustaining the level of financial literacy needed for participants to make effective choices amongst the alternatives so offered -- suited to their age and career status -- that might enable them to realize better post-retirement incomes from the contributions they are making. This has been well documented in current behavioral finance literature and in comments already submitted to the Department of Labor in response to their request for comments (RIN 1210-AB33).

The results of current shortcomings in providing for and sustaining needed levels of financial literacy broadly across DC plan participants have been wide distributions of asset allocation choices across participant accounts that may not, and likely are not, compatible with the objective that may be best suited for many of those participants (i.e. to be investing as if their DC funds are to be their primary supplement to social security income upon retirement). To be sure, there is a portion of DC plan participants for which their asset allocation choices are well suited; however, there is a material enough proportion for which this appears not to be true, such that some additions to the current QDIA regulations might be highly beneficial. This will be especially true if there is to be any expansion of the participant base as is addressed below in Comment #2.

The observation from the recent Conference that a slightly expanded use of the QDIA regulations that might be able to substantially address this problem is covered below.

The modifications would be to

- 1) require all DC plans to offer at least one QDIA qualified fund,
- 2) require all DC plans to default all new participants into that fund, and
- 3) require all DC plans to restrict those new participants from adopting allocations to any non-QDIA fund offered by the plan until the later of (i) six months or (ii) the time for that participant to complete two plan sponsored education events.

This will build on the basic acceptability of QDIA funds to create a safe harbor for new participants, without rushing them into making long term choices or establishing potentially long term practices for which they may not be fully prepared. The requirement that the participant further identify that they feel ready to make alternative choices will also create a safety bias for participants without unduly restricting those who feel that they have achieved the level of financial literacy they need to make choices about other, non-QDIA asset allocation choices for themselves.

Comment 2: Increasing Access and Take-up Rates on DC plans through simplified offerings

Though it is encouraging that 61% of private industry workers – a meaningful percentage – have access to DC plans and take-up rates stand at 70%, according to the most recent Department of Labor National Compensation Survey (March 2009), two simplification solutions surfaced at the Conference that might further improve these statistics and further broaden participation.

The first simplification solution, required auto enrollment, and on one paper, auto enrollment combined with a small (1.5%) required employer minimum contribution, provided for two possible modest changes that would demonstrably and respectively increase both participation and levels of early stage employee engagement. The combination would also bring early attention to newly hired employees about the presence of the plan, to contribution levels and to their readiness to make good asset allocation choices going forward.

When these are combined with the safe harbor delay and education period discussed above enabling interim contributions to remain channeled and invested in a QDIA choice, these fairly long term decisions can then be made outside of the usually confusing period for employees that characterizes the early months after their initial hire date – without losing the benefits of starting the employee's contributions from that first date of hire.

These steps can improve upon the participation, or the related take-up, statistic.

The second simplification solution addresses the question of increasing access.

Many have observed that the complexities of creating and properly maintaining DC plans for some companies is a significant enough burden – either because they are small and lack the minimum administrative scale to take on this requirement, because their industry operates with large numbers of temporary workers for which the additional hiring overhead might be viewed as excessive, because their industry operates on margins so narrow that such additional overhead would be a burden, or for other reasons – that they have felt unable to go through the process of setting up a full plan and preparing for its administration.

The suggestion that was presented at the Conference was to have a form of 401(k) that would be entirely comprised of one or more QDIA funds. Such plans could be administered at minimal additional cost outside of employer sponsors -- even by 401(k) TPAs. The only obvious additional requirement for such simplified plans might be restrictions on administrative fees to, for instance, no more than \$200/participant/year and for fund expense ratios to not exceed 0.99 in order to qualify.

Such simplified plans could become broadly available to many employers who currently have very legitimate reasons for not being able to bear the administrative costs of maintaining such plans. As most of these companies also are likely to use third party payroll providers, such as ADP, the complexities of directing a portion of each payroll run to these external TPAs would be minimal as well.

Comment 3: Adding reporting on the potential for differing levels of retirement phase income

Behavioral finance literature and other comments already submitted to the Department of Labor have noted that, especially given the low levels of financial literacy that prevails across many DC plans, it is difficult for most current and likely future plan participants to regularly and easily make the calculations needed to determine what levels of retirement phase income might be achieved given their current contribution rates, those of their employer and the time they have to retire. Calculators are available, but there are no standards or guidelines as to their use and few if any limitations that might restrict their incorrect use.

With the appropriate disclosure about forecasts relating to the future and the possible impact of future events, it is possible for a standard set of assumptions to be defined that could be universally utilized in DC plan reporting to provide information about the potential for different retirement phase income levels to go along with the required disclosures on fund balances in regular reports.

Such a calculation could utilize historical rates of return from a typical QDIA fund, years to retirement, current contribution levels, and current quotes for lifetime annuity rates with a refund provision to provide for such a standardized estimate to be included in each regular participant statement.

Entities, such as the PBGC currently survey the insurance industry for annuity rates, and it would not be a significant additional burden for such entities to similarly survey and publish the results of rates for immediate annuities with refund options for use in such calculations.

Standard calculators could utilize these assumptions as defaults from which more sophisticated employees could easily determine the effect of changes to contribution levels and other assumptions they might like to make.

This would facilitate more ready comparison and at least one form of regular visibility as to the potential for the current contribution decisions of the participant to potentially realize different income levels after retirement.

A further paper at the Conference suggested the presentation of not just one such number, but a range of numbers based on different retirement ages both in front of and following age 65. Yet another paper of interest at the Conference suggested a means for adding a contributions glide path tracker that might further be able to signal the need for additional contributions in order to achieve pre-defined desired benefit targets.

Both of these later papers demonstrated effective additional improvements on the concept; however, even without them, there was very broad consensus at the Conference as to the merits of adding at least some form of basic reporting on the potential for realizing various income levels post retirement that would be standardized and would be easy to understand and to use for a wide range of plan participants.

Comment 4: The merits of developing a Qualified Lifetime Income Alternative (QLIA) standard

The final theme that was echoed at the Conference was that there remains as wide a variety of options, though differently directed, for DC plan participants once they reach retirement, as there were for those participants when they were working and still in their accumulation phase. The benefits of the development of the QDIA regulations for accumulation phase activities have been widely recognized. There was discussion at the Conference about the merits of having a similar set of regulations that might define a similar subset of options for the decumulation, or income, phase. Because of their likely similarity to the regulations that went into QDIAs, this related set of potential regulations was referred to as QLIA, standing for Qualified Lifetime Income Alternative.

Like with QDIAs, the basic principle for QLIAs is that they are not intended to restrict retirement phase participants from finding income generating instruments, asset allocations, distribution levels, advisors and rules that best suited their particular circumstance.

Likewise, it was evident that the range of options currently available to participants in retirement matches the range that was available during that participant's accumulation phase years, ranging from emerging markets stock funds to annuities, and that that choice should be retained. Yet, there was no QDIA-like way to differentiate the retirement phase options or their suitability as a mainstream choice for providing for retirement phase income. Whether assets were held in an IRA or a variable annuity, there was still a wide range of potential for year to year changes in retirement phase income in the currently available set of retirement phase options. A means of differentiation seems clearly needed.

One point of commonality for the QLIA with the existing QDIA regulations was that the inherent standards for continued diversification and professional management would equally need to apply. There are two additional criteria that were discussed that might further distinguish QLIA alternatives:

- 1) That the alternative must contain some form of longevity protection. These came in the form of immediate life annuities as well as in the form of late stage, deferred life annuities combined with a managed fund paying out in between retirement and the start of the deferred annuity start date. For this latter variant, sometimes referred to as "longevity insurance," a retirement date of age 65 and a deferred annuity start date of age 85 was often a representative illustration.
- 2) That the potential for the payout stream -- whether generated by an immediate annuity or by a managed fund either in a continued 401(k), an IRA or a variable annuity combined with longevity insurance -- must have a definably low potential to vary from year to year or to become exhausted or become significantly mismatched before any combined longevity insurance became active. Immediate life annuities with a refund provision would clearly meet this standard, however, there was little to differentiate any of the fund based options combined with a suitable form of longevity insurance that might also be able to qualify.

Using these two criteria, like with the QDIA, a QLIA would define some limitations on the lifetime income alternatives that were being offered while still providing (i) for a range of innovations to still be developed and (ii) for retirement investors to choose other alternatives that might be better suited to their circumstance.

Conclusion:

Amongst the many papers and related topics discussed at the recent Society of Actuaries conference, the four comment areas discussed above seemed particularly relevant to the Department of Labor's recent inquiry about income options for beneficiaries in retirement plans. These four areas seemed to be of particular utility since all address significant identified and current shortcomings of the current Defined Contribution system while not requiring significant departures from regulatory, payment or administrative infrastructure, or institutional arrangements that have already been developed or are already largely in place.

The opinions and observations expressed above are solely those of the author and do not reflect the opinions of the Society of Actuaries, of any of the other presenters or commentators or any other participant in the Conference. They are offered as a compilation of observations made by this author while in attendance at the Conference.

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