Insured Retirement Institute

Guaranteed Lifetime Income Options within Employment-Based Plans

Leveraging Advantages and Overcoming Challenges

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About the Insured Retirement Institute: The Insured Retirement Institute (IRI) is a not-for-profit organization that for more than twenty years has been a mainstay of service, commitment and collaboration within the insured retirement industry. Today, IRI is considered to be the authoritative source of all things pertaining to annuities, insured retirement strategies and retirement planning. IRI proudly leads a national consumer education coalition of nearly twenty organizations and is the only association that represents the entire supply chain of insured retirement strategies: Our members are the major insurers, asset managers, broker-dealers/distributors, and 150,000 financial professionals. IRI exists to vigorously promote consumer confidence in the value and viability of insured retirement strategies, bringing together the interests of the industry, financial advisors and consumers under one umbrella. IRI's mission is to: encourage industry adherence to highest ethical principles; promote better understanding of the insured retirement value proposition; develop and promote best practice standards to improve value delivery; and advocate before public policymakers on critical issues affecting insured retirement strategies and the consumers that rely on their guarantees. Visit www.IRIonline.org today to experience the vast resources of the Insured Retirement Institute for yourself.

The issue of income in retirement is upon us now. Baby Boomers started becoming eligible for Social Security benefits in 2008, the year the first Boomers turned 62. In 2011, 44% of individuals who first claimed Social Security benefits did so at age 62. As employers have shifted from defined benefits plans, which provided guaranteed lifetime income in retirement, to defined contribution plans, which typically pay out a retirement benefit in a lump sum, the responsibility for managing assets in retirement is now with individuals.

As a result, individuals must now identify strategies and solutions to help effectively manage the multiple risks that may arise in retirement. Guaranteed income products such as annuities can help individuals better manage these risks. Previous IRI research has identified some of the risks that guaranteed products could help manage, including longevity risk, market risk, excess withdrawal risk, asset allocation risk, sequence of withdrawal risk, and incapacity risk.

A way to help individuals who are saving for their retirement through a defined contribution plan to manage these risks is by providing a mechanism within the plan through which they have the option to convert a portion of their accumulated assets into a guaranteed income product. This report will examine the following points:

- Individuals are not well prepared to manage their income in retirement on their own.
- Including guaranteed income options within employment-based defined contribution plans as a consideration for retirement planning.
- Advantages of providing guaranteed income options through employment-based defined contribution plans for both employees and employers.
- Challenges around providing guaranteed income options through employment-based defined contribution plans.

Key Findings

- Providing guaranteed income options within an employment-based plan is appealing to plan participants. According to one study, 89% of participants agree they would like their plan sponsor to provide them with income-generating options in their retirement plan.
- Retirement products that include guaranteed income features can help Americans ensure they have sufficient income in retirement. IRI research shows Boomers value guarantees and the value of those guarantees increases with age. Among Boomers age 60 to 66, 19% stated the most important trait of a retirement product is guaranteed income each month compared with 14% of Boomers age 50 to 54.
- Advantages to plan participants of in-plan guaranteed income options:
    - Protection against market volatility close to retirement
    - Access to ongoing employer-provided financial education on guarantee options
    - Lower fees through group purchasing
- Advantages to employers of in-plan guaranteed income options:
    - Increased utility of the defined contribution plan as a labor force management tool assisting employees to retire when planned
    - Increased participant satisfaction and confidence, leading to better participant outcomes.
- Challenges providing in-plan guaranteed income options

    - Fiduciary concerns are the most significant obstacle to increased offering of guaranteed lifetime income options.
    - Current low take-up rates
    - Flexibility of product offerings
    - Portability of products
    - Concerns regarding giving up control over retirement assets
- Evidence from IRI's research on Boomers shows few Boomers are very to extremely knowledgeable about investing in securities.
- Results from the National Financial Capability Study indicate relatively low levels of financial literacy.
- Research from IRI and Cogent Research shows annuity owners are increasingly more likely to agree that annuities are a critical part of a retirement strategy, increasing by 18 percentage points from 55% in 2011 to 73% in 2012.

Are Individuals Prepared to Manage Their Assets in Retirement?

One way to assess whether Americans are financially prepared for retirement is to determine their level of financial knowledge. In 2009, in consultation with the U.S. Department of the Treasury and the President's Advisory Council on Financial Capability, the FINRA Investor Education Foundation commissioned a national study of the financial capability of American adults. In this study, individuals were exposed to a battery of questions covering fundamental concepts of economics and finance expressed in everyday life. The questions involved calculations involving interest rates and inflation, principles relating to risk and diversification, the relationship between bond prices and interest rates, and the impact that a shorter term can have on total interest payments over the life of a mortgage. The results, illustrated in the table below, indicate relatively low levels of financial knowledge.

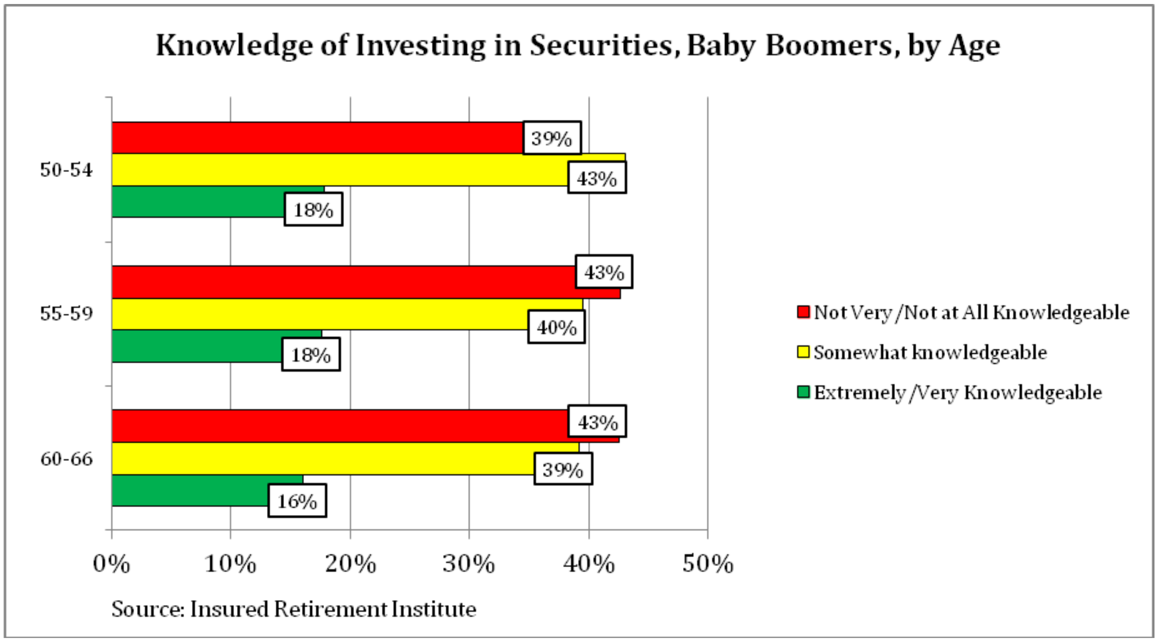
Measures of Financial Literacy

	Correct	Incorrect	Don't Know
Interest Rate Question	65%	21%	13%
Inflation Question	64%	20%	14%
Bond Price Question	21%	44%	34%
Mortgage Question	70%	16%	12%
Risk and Diversification Question	52%	13%	34%

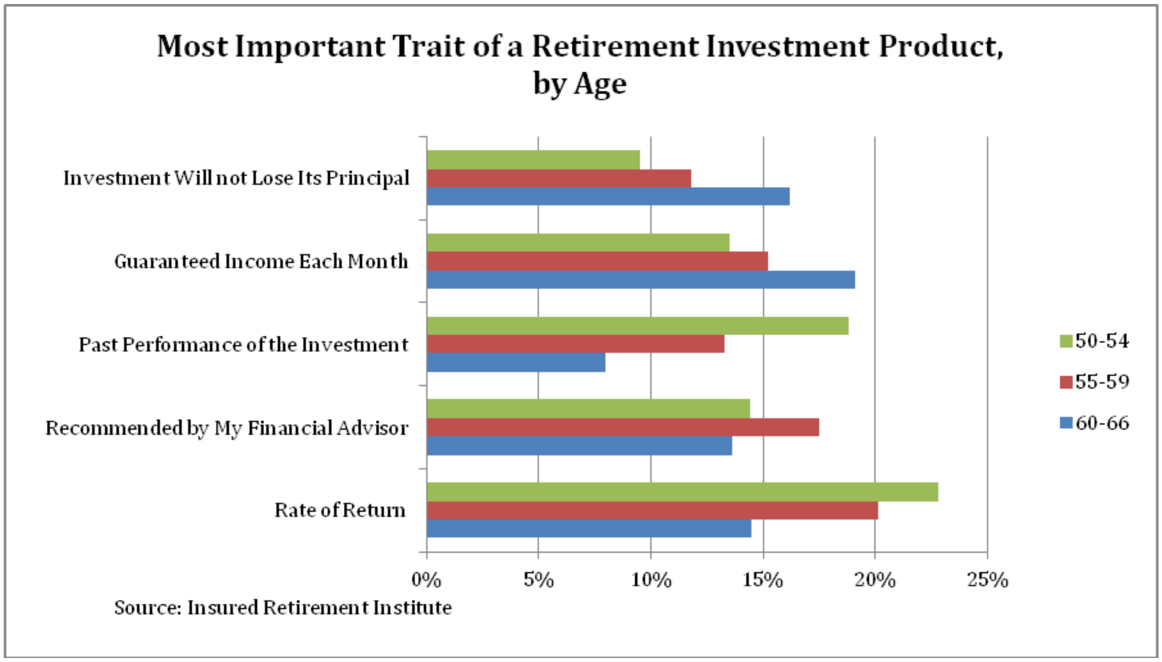
Source: FINRA Investor Education Foundation

While the correct response to any single question sometimes exceeded 60 percent, fewer than half of respondents (46 percent) correctly answered both a question about interest rates and a question about inflation. Less than one-third (30 percent) correctly answered those questions plus a question about risk and diversification correctly. Fewer than 10 % of respondents were able to answer all questions correctly.

In order for individuals to be able to manage their retirement assets on their own throughout their retirement, which could be longer than twenty years, knowledge of investing in products such as securities would be helpful. Yet, IRI research shows most Boomers, among all age groups analyzed, lack knowledge on investing in securities. A large majority of Boomers, a little over 80% in all age categories, reported they are somewhat to not at all knowledgeable of investing in securities. While less than one-fifth of Boomers report they were very to extremely knowledgeable about investing in securities.



The evidence from these two studies demonstrates that most Americans lack the financial skills necessary to manage their assets in their retirement years. As a result, retirement products that include guaranteed income features could play an important role in the retirement plans of most Americans. IRI has found through their research on Boomers that these guaranteed income features are highly valued. In fact, the value Boomers place on these features increases with age as they approach retirement. For example, among Boomers age 60 to 66, 19% stated the most important trait of a retirement product is guaranteed income each month compared with 14% of Boomers age 50 to 54. Research conducted by IRI and Cogent Research demonstrates that current owners of annuities highly value these products as a part of their retirement strategy. In their joint study, *Evolution of the Annuity Industry™ 2012,* 73% of annuity owners strongly or somewhat agreed with the statement, "I believe annuities are a critical part of a retirement strategy." This is an increase of 18 percentage points from 2011.



While these products will be components in the retirement income planning process, Americans will need assistance in making the retirement financial decisions appropriate for them. An avenue to provide some assistance lays with providing guaranteed income solutions within employment-based defined contribution plans such as 401(k)s.

Advantages of Guaranteed Income Options Within Defined Contribution Plans

Advantages to Employees

Offering guaranteed lifetime income options through employment-based defined contribution plans has many advantages for individuals. There is a strong connection between saving for retirement and work. For many Americans, the primary vehicle for saving for their retirement is through an employment-based plan. According to the Bureau of Labor Statistics, in 2012 68% of all workers in private industry and state and local governments had access to a retirement savings plan through their employer. Even for non-employment-based plans such as IRAs, the majority of dollars added to IRAs comes from employment-based plans. According to the Employee Benefit Research Institute, in 2010 almost twelve times more dollars were added to IRAs through rollovers from an employment-based plan than from direct contributions.

Given this strong connection between retirement savings and the workplace, many plan participants want their employer to provide in-plan options. According to BlackRock's *Annual Retirement Survey: What Retirees Have to Tell Us About the New World of Retirement*, 89% of participants agree they would like their plan sponsor to provide them with income generating options in their retirement plan and 85% find the idea of a fund that automatically converts savings to guaranteed income in retirement appealing. Purchasing guaranteed income products through the employer's plan provides participants with lower costs due to group purchasing. Participants also benefit from the screening process employers use in selecting service providers for their plans. However, this creates challenges for employers with regard to their fiduciary liability. Further discussion of this issue follows in the challenges section of this report.

Protection Against Market Volatility Close to Retirement
The protection available with annuities is particularly valuable in protecting plan participants during the several years before and after their retirement date. During this time, market volatility can be especially harmful to retirees because they have less time to recover and a larger asset base at risk. Market volatility can also cause income volatility when income is based on assets held in the market. It can also markedly increase the probability of outliving one's assets, especially if a downturn occurs early in retirement. Annuities with their guaranteed income distribution options can help stabilize at least part of a retiree's income and can provide longevity protection.

Benefits of Employer-Provided Education
The need for education on income needs in retirement is essential. The employer is a trusted source of financial education. Employers and service providers currently are providing financial education on the topic of saving for retirement. Adding in education on managing those assets in retirement can be seen as the next step. Employees will benefit from ongoing education on the value of guaranteed income options. Specifically, within an employment-based plan, participant education materials should clearly and concisely explain the benefits of guaranteed lifetime income products and how they compare to other options that are offered by their plan. This would include information such as the historic return patterns of each of the options, the specific risk ratios associated with each of the plan choices, the expense ratios or fees associated with each option, and an explanation of differences between and among different options. Similar educational information is already provided in the accumulation stage under the plans. However, this creates challenges for employers with regard to their fiduciary liability. Further discussion of this issue follows in the challenges section of this report.

The education efforts should present guaranteed income products as a component of an individual's plan for providing income in retirement, not as the only solution. Many elderly individuals have loss aversion when it comes to their finances and may see giving up control of their assets for a guaranteed income product as a form of financial loss. See the section *Concerns Regarding Giving Up Control Over Retirement Assets* for further detail on this topic.

Moreover, while it is clear that, at a minimum, participants should receive educational materials on lifetime income options as they near retirement and the distribution stage, it would also be prudent to provide extensive information earlier in a participant's career with the employer. This would ensure that participants would be able to formulate an appropriate long-term retirement plan.

A simple first step is to require benefit statements that include the annuity equivalent of a participant's benefit. This was the goal of the Lifetime Income Disclosure Act of 2011. When individuals receive their benefit statements today, they see their benefit expressed as a single lump sum amount. That naturally leads them to think of their 401(k) plan benefit as a lump sum amount, not as a source of guaranteed income for life. This can have a subtle but powerful effect on their decision regarding how to receive their 401(k) plan benefit. It is critical that participants be made more aware of the possibility of receiving at least a portion of their benefit in an annuity form that protects them against outliving their savings. Knowing the amount of monthly income they can expect will help employees evaluate whether they are on the path to retirement security.

In this regard, benefit statements that provide annuity equivalents would be better coordinated with Social Security benefit statements, which only express benefits in the form of a life annuity. Individuals would be able to determine the total retirement income available to them during their retirement. Thus, the proposal would build on the success of Social Security benefit statements, providing additional information regarding retirement income.

Advantages to Employers
One of the advantages of a defined benefit plan to employers is the plan's utility as a labor force management tool. When an employer needs to downsize the workforce for economic or business reasons, the employer could use early retirement options within the defined benefit plan. Some of the advantages of downsizing the labor force through early retirement incentives are: It is less disruptive to remaining works and retired employees remain connected to the employer, allowing the possibility to incent former workers with key skills back into employment if a need arose.

Prudential found in *The Future of Retirement and Employee Benefits: Finance Executives Share Their Perspectives* that a large percentage of respondents in the 2012 survey (69%) say they believe a significant number of their companies' employees will be forced to delay retirement due to inadequate savings. Delayed retirements can limit companies' abilities to hire new staff and provide advancement opportunities for existing talent. Respondents also frequently predict that delayed employee retirements would affect their company's ability to control workforce costs (44%). As a result, some employers are considering ways to enhance their defined contribution plans to assist employees to retire when planned. Among the options being considered are guaranteed lifetime income products, indicated by 41% of respondents.

In a separate study, *Better Participant Outcomes Through In-Plan Guaranteed Retirement Income*, Prudential found, when in-plan guaranteed retirement income options are added to defined contribution plans:

- Participant satisfaction increases,
- Participant confidence increases, and
- Participant outcomes improve due to better long-term investing behaviors.

In addition, the research found that plan participants with in-plan guaranteed retirement income options were more inclined to stay invested during market turmoil, were better diversified, and contributed more than participants without guaranteed retirement income.

Challenges to In-Plan Guaranteed Income Options

In addition to the advantages to in-plan guarantee options, there are challenges that need to be overcome. The following gives a brief overview of some of those challenges.

Fiduciary Liability
Fiduciary concerns are the most significant obstacle to increased offering of guaranteed lifetime income options. The Department of Labor (DOL) has adopted rules meant to help employers understand what they must do to satisfy their fiduciary obligations when choosing to offer an annuity option in their plans. Unfortunately, these rules include a broad, vague requirement that employers conduct a detailed review of an insurer's financial condition and conclude that insurer will be able to meet all of its long-term commitments. These commitments are significant given the nature of the insurer's liability in the

participant's lifetime. This is a task for which most employers are not well equipped and is fraught with legal liabilities. Therefore, this presents a serious deterrent for a plan sponsor.

With regard to participant education, plan sponsors are concerned that any attempt to educate participants about these products and provide relevant information could create potential fiduciary liability, either because the information might be deemed "investment advice" under Employee Retirement Income Security Act (ERISA), or because any deficiency in such information could constitute inadequate disclosure and/or misrepresentation about a plan product or feature. The DOL could address these concerns by amending its existing regulatory materials on this subject (including Interpretive Bulletin 96-1, Field Assistance Bulletin 2007-1) or by issuing new guidance to clarify that plan sponsors can provide information about lifetime income products to assist their participants in evaluating available alternatives, whether inside or outside of the plan, and that providing such information will not give rise to any potential fiduciary liability.

The DOL could help plan sponsors by clarifying that they will not face fiduciary liability for providing educational materials to their plan participants. The DOL should develop and distribute a model disclosure that would accompany an illustration of the product and therefore mitigate the fiduciary responsibility of the plan sponsor.

When promulgating the qualified default investment alternative (QDIA) regulations, some in the industry asked the DOL to include stable value products (such as fixed products that include guaranteed annuity purchase rates) as one of the options that could be used as the QDIA, and the DOL declined to do so. This issue should be revisited because QDIAs are important safe harbors that plan sponsors rely on. The fact that there is a guaranteed feature should not disqualify these products from being QDIAs. It may require some additional disclosure to participants to ensure they understand the fee structures associated with these products.

Low Take-Up Rates for Current Guaranteed Products

The issue of low take-up rates can be resolved through participant education on the value of these products. However, much of the current education is on the accumulation phase of saving, and little attention has been paid to the decumulation phase. Prudential found in *Better Participant Outcomes Through In-Plan Guaranteed Retirement Income* that nearly half of those who had not invested in an in-plan guaranteed retirement income option said it was simply because they were unaware one was available. Once participants were informed, perceptions about and interest in guaranteed retirement income was considerable. Guidance is needed in the area of participant education, especially if plan sponsors and providers are being asked to increase their education efforts about distribution, including lifetime income options.

Framing of the allocation options within the plan can have significant impacts on outcomes. A metastudy by Allianz, *Behavioral Finances and the Post-Retirement Crisis,* found in a study by Jeffrey Brown from the University of Illinois that positioning guaranteed income products as income solutions dramatically increases their attractiveness.

Flexibility of Product Offerings

A disadvantage for participants in selecting an in-plan guaranteed lifetime income option could be flexibility, if the product offered in-plan lacks features that a participant could choose in the open market. Options that address inflation, death benefits, and liquidity concerns might not be available in the in-plan option. However, the plan sponsor can avoid this situation by choosing products with these features. In addition, more than one type of guaranteed product could be offered.

Portability of Products
Lifetime income products contain special costs for their guaranteed features, and it is assumed that the product will remain in the plan until the participant can elect the guaranteed feature, thereby getting the benefit of what he or she paid for. However, due to service provider changes and merger and acquisition activity, that product might not remain as an option for the plan participants. The portability of guaranteed lifetime income products is a big concern for plan sponsors, and the IRA rollover rules currently do not offer a clear solution. These issues are of particular concern to small employers, who do not have negotiating power to cause a new vendor to make system changes necessary to support guaranteed lifetime income products. The Treasury Department may conclude that a solution would require a statutory change to various distribution provisions of the Internal Revenue Code affecting 401(k), 403(b), 457(b), and other plan types.

Concerns Regarding Giving Up Control Over Retirement Assets
An AARP and American Council of Life Insurers (ACLI) study *What Now? How Retirees Manage Their Money to Make It Last Through Retirement* found that retirees are very loss adverse. Given this loss aversion, it seems intuitive that retirees would prefer guaranteed products. However, the study found the retirees who were more loss adverse were not as open to annuitized income solutions as the less loss averse. Allianz in *Behavioral Finances and the Post-Retirement Crisis* highlights findings by Prof. Eric Johnson at Columbia University that retirees view giving up control as a form of loss. Positioning guaranteed products as a way of gaining control over income and spending could help alleviate retirees' concerns over loss of control. Prof. David Laibson of Harvard University agrees positioning of annuities is important in getting participants to accept them. If you frame annuities as guaranteed income for life, investors are all for it, but the minute you frame it as a loss of control, they lose interest. Laibson believes investors will feel more secure about annuities if they are framed as a small piece of a very large portfolio. This is less threatening than putting all of their assets into one account with limited liquidity.

Conclusion

We are at the beginning of a long and complex debate. The question of how average Americans will manage their assets in retirement presents many complex issues to resolve. As demonstrated here using data from the FINRA Investor Education Foundation and IRI, individuals are not prepared to take on this task. Assistance is needed. The question of where that assistance will come from is still an open one. This report has explored the possibility of providing this assistance through employment-based defined contribution plans. While this option presents many advantages to participants, such as ease of transition of assets into guaranteed products, lower rates for fees, employer selection of service providers, and employer provided ongoing education, there are many challenges for employers. From the employer perspective, chief among these challenges are the fiduciary liability concerns regarding provider selection and the determination of whether information provided is education or advice.

The issues of an aging population, increased longevity, and the coming large wave of retiring Boomers means this debate is certain to have serious implications for American society for many decades to come.

Methodology

The Insured Retirement Institute (IRI) commissioned Woelfel Research, Inc., to conduct a survey of Boomers approaching retirement or who have recently retired. The research was conducted by means of telephone interviews with 803 adult Americans age 50 to 66. The sample was selected from a list of households in this age group, developed by Accudata, Inc., by compiling data from available sources such as motor vehicle records. Results were weighted by age and gender to the 2010 United States Census. Data were collected during February and March 2012.

Supporting data were derived from publicly available research from financial services companies (Allianz, BlackRock, and Prudential) and other organizations (AARP, American Council of Life Insurers, Cogent Research, Employee Benefit Research Institute, and FINRA Investor Education Foundation).