The Income Revolution Hype or Hope?

New research council aims to dispel myths about retirement income solutions in DC plans

What is the best way to address the impending retirement of the Baby Boomer generation and the need to generate income from 401(k)s and other such defined contribution savings plans, in retirement?

That was the focus of a recent half-day forum held by the recently formed **Institutional Retirement Income Research Council (IRIRC, also known as I-RIC)**, a session designed to provide industry experts, advisers, consultants, and plan sponsors with an overview of the income issue, as well as practical considerations about implementation of potential solutions, and details of product specifics.

While IRIRC co-leader **Martin Schmidt, Principal at MAS Advisors**, noted that "there is no one right [retirement income] solution" for a defined contribution plan, or the participants covered by that plan, he stated that the Research Council intends to be a provider of "solutions and information" for plan sponsors to use in determining whether or not to offer a retirement income program for its participants, and in what form.

INSTITUTIONAL RETIREMENT INCOME RESEARCH COUNCIL

Innovation, Communication, Evaluation.

Coping with the DB to DC Shift

The shift in emphasis from defined benefit (DB) to defined contribution (DC) plans also has placed a greater value on individual choice, but many participants are making poor decisions, said **Jeffrey Brown, Professor in the Department of Finance at the University of Illinois**. In light of that, he said the industry is moving toward a policy of "libertarian paternalism," which falls somewhere in the middle of DB and DC philosophies. He cited the examples of automatic enrollment and qualified default investment alternatives (QDIAs) as examples of policies that preserve individual choice for people

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who want it, but also provide sensible default options for the rest of the population during the accumulation phase of retirement saving. The question: Will this default process be mimicked in the withdrawal phase? Brown pointed out that the aspect of making retirement income security last a lifetime largely has been ignored thus far.

Brown noted that the IRA required minimum distribution rules do not mandate that those distributions be made in a sustainable way. Further, laws traditionally have imposed fiduciary risk when an employer chooses an annuity provider, rather than when employers fail to provide guaranteed income; therefore, some plan sponsors might think that the best way to reduce fiduciary responsibility is to not provide an income solution at all. "This is an area that's likely to be revisited from a policy perspective as we move forward," Brown said. He noted an emerging recognition in Washington that employers should not be penalized for "doing the right thing." Although many of the retirement income solutions are new, he noted: "It's in a plan sponsor's—and certainly in a participant's—interest to make that decision [to implement a retirement income solution] sooner rather than later."

"[Although] we have witnessed a tremendous amount of innovation in the retirement income space in the last few years," Brown said, there are many challenges that plan sponsors face. For instance, it is a "paradigm shift" for employees to think about retirement income—a sentiment reiterated throughout the event. Another problem is what Brown described as the "mis-framing of annuities." Americans think in an investment mindset and, in that frame of mind, annuities are unattractive. Instead, Brown suggested that Americans reframe their way of thinking to a consumption-based outlook, because, when considering how much one actually needs to consume in retirement, annuities look more valuable. Brown cited research showing that when the same information about annuities was presented in the investment frame—focusing on account balances, rates of return, and liquidity issues—the investments appeared risky, and only one in five people thought they were attractive options; contrarily, annuities presented in a consumption frame, emphasizing longevity risk and the ability to consume goods and services in retirement, were said to be attractive by seven in 10 people. "People are willing to value guaranteed income when you talk to them about it in a consumption frame," he said.

Further, Brown said, "Participants take their cues from the employer." Employees look to their employers for both explicit and implicit investment advice and, therefore, participants likely will have a greater sense of security when they think that their employer is vetting or endorsing an investment option.

A New Communication Focus

The challenge of communicating with participants about retirement income was laid out by ***PLANSPONSOR*** CEO **Charles Ruffel,** who said, "We're all children of an equity market here….An annuity has become a difficult word in itself." Retirement income is one of the most important issues we face, he said as part of a panel discussing the conceptual outlook for retirement income. Echoing Brown's earlier comments, he noted how default contributions have transformed the accumulation side of the industry; the political will to make defaults part of the distribution phase could bring about the same transformation on the withdrawal side.

A Growing Market

The marketplace for retirement income products has been expanding consistently, and the IRIRC panelists put some of the many features in perspective. Of course, it is hard to give a whole picture, because "products keep popping out the woodwork," said **Clark Frese, Senior Consultant at Asset Strategy Consultants**. Moreover, with the various bells and whistles, how does a sponsor make these products easy for a participant to understand?

For sponsors, it is no small challenge to select the right type of solution and then choose the best product within that type of solution. That is why an adviser is very helpful, said **Chris Raham, Senior Actuarial Adviser at Ernst & Young**. He noted that his firm has made progress comparing products within product types—such as comparing guaranteed minimum withdrawal benefits to one another—but that evaluating the different types is "work that's yet to be done" (for instance, how to compare using a managed payout fund to an in-plan annuity option). "To us, the difficulty inside individual product types is hard enough….Cross-product types are virtually impossible," he said. Even the terminology manufacturers have coined for themselves differs. "It's sort of like the Wild West out there," Frese said.

One sensitive area of product complexity is fees, and that could hinder their adoption. As Ruffel noted, "[With today's emphasis on transparency in fee structure,] any product that brings with it a complex fee structure is going to face a challenge." **John Fenton, Principal at Towers Perrin**, explained how some fees are implicit, such as the in-plan deferred fixed annuities in which a participant buys units of future income. In other products, fees, such as investment management, are more explicit. There are also differences in what you are paying for, such as the richness of the guarantee, he noted. Some products offer a step-up guarantee, while others provide a rollup benefit. Other differences among products include the choice of equity and the amount and complexity of underlying funds. The financial crisis—in addition to raising new concerns about the stability of insurers—is adding an extra layer to fees, as the fee level of a guarantee could go up in light of the lower interest rates and higher volatility in the market, said Fenton. "We wouldn't be surprised to see some price increases," he said. Insurers will have to be aware and work toward controlling costs, and sponsors and advisers will need to know the right questions to ask about fees and how they might change.

While Fenton said the fee comparison is no doubt challenging, the job is getting a little bit easier. "Now that we are seeing a few products, we are able to do some comparison," he said, noting that IRIRC was making available some comparison charts for plan sponsors to use when evaluating various types of income products. The panelists were optimistic that there will be future standardization among what might seem like silos of product pushing by individual firms. Right now, investors looking at the products are bombarded every step of the way with a nuance, Raham said, but many of the manufacturers are realizing that there needs to be a larger education effort in the adviser and sponsor community. "Along these major product types…I think you will see more homogenization," he said.

"People are willing to value guaranteed income when you talk to them about it in a consumption frame." —*Jeff Brown*

There will have to be some standardization among these products at the recordkeeper level in order for them to succeed, the panelists said. Although, currently, many of these products are only available on certain recordkeeper's platforms, in the longer term, "I think you are going to start to see this as a completely open-architecture environment," he said.

However, with all the expected changes in the near future, **Martha Spano, West Division Practice Leader at Watson Wyatt,** closed by saying, "Perhaps next year we won't be discussing the retirement income revolution, we will be discussing the retirement income evolution." ■

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Martha Spano, West Division Practice Leader at Watson Wyatt, said employers are beginning to take more interest in providing retirement income, but cautioned that “no one wants to be the first one; just like no one wanted to be the first one with the target-date solution.” Jay Vivian, Principal at Corn Hill Associates, talked about his former role as a plan sponsor at IBM in setting up a retirement income solution.

John Pickett, Senior Vice President at RBC Dain Rauscher, outlined a few criteria for what kinds of plans he believes are especially well-suited for these retirement income solutions; plans with a high proportion of Baby Boomer-age participants and larger participant balances are vital—after all, a small account balance annuitized into a guaranteed income stream does not translate to much in terms of a monthly payout. The ultimate fit, he said, is a high-balance plan that used to have a DB plan and has an “aware” plan sponsor.

Vivian added that there are several questions sponsors and advisers should ask when considering whether a plan is a good fit: Do a lot of participants stay in the plan after retirement? Does the plan have a high fiduciary focus?

The sponsor needs to look for something with both flexibility and portability so that participants can take the benefit with them if they leave employment before retirement. While these products are still in their infancy, it is nevertheless in the best interest of both the sponsor and participant to offer them, Spano noted. “Many manufacturers are very willing to work with plan sponsors to overcome some of these challenges,” she said.

The IRIRC is an independent retirement income think tank created to advance the interests of retirement savings plan participants, plan sponsors, and plan advisers and consultants, as they relate to the retirement income industry. The Council’s objective 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.

More information, including a new white paper, description of product types and distribution channels, glossary of terms, and product comparison criteria, can be found at www.irirc.com.

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(The IRIRC’s membership also includes other industry experts and plan advisers not listed above.)

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