

# How Green is your Retirement Landscape Retirement Income Update

Western Pension & Benefits Conference

***Martin Schmidt***  
***May 17, 2011***



*Innovation, Communication, Evaluation*

# The Major Elements of Today's Discussion



- Evolution of Defined Contribution Plans
- Institutional Retirement Income Council – Our Mission and Vision
- Update from Washington
- Why Plan Sponsors Should Consider Institutional Retirement Income Solutions
- Retirement Income Solutions – Current Generation
- Types of Guaranteed Institutional Retirement Income Solutions
- Retirement Income Solutions – Future Direction
- Key Considerations for Plan Sponsors
- Industry Challenges
- Questions and Answers

# Evolution of Defined Contribution Plans



- Defined Contribution becomes the retirement plan
    - DC plans cover nearly twice the participants as DB (79.8M vs. 42.1M)\*
    - DC plans are 13 times more prevalent than DB (646,000 vs. 49,000)\*
  - Shifts key risks from plan sponsor to participants: **market, inflation, longevity**
  - Applying lessons from “behavioral finance” improves outcomes
    - More is not always better (choice, complexity, disclosures)
    - Power of defaults
  - How does participant receive sustainable lifetime income stream?
    - Initially conceived as supplemental savings plans, now primary retirement source outside of Social Security
    - Pension Protection Act addressed accumulation issues, not income issues
    - Value created through pooled risks
- \* Private Pension Plan Bulletin, Abstract of 2006 Form 5500 Annual Report, US Department of Labor Employee Benefit Security Administration, December 2008

# Institutional Retirement Income Council

## Our Mission and Vision



- Independent think tank of 15+ Consultants, Advisors, Attorneys, and Guest Academics. We Focus on Institutional Retirement Income Solutions

### Mission

Help Facilitate shift of DC plans from Supplemental Savings Plans to Vehicles Providing Retirement Security

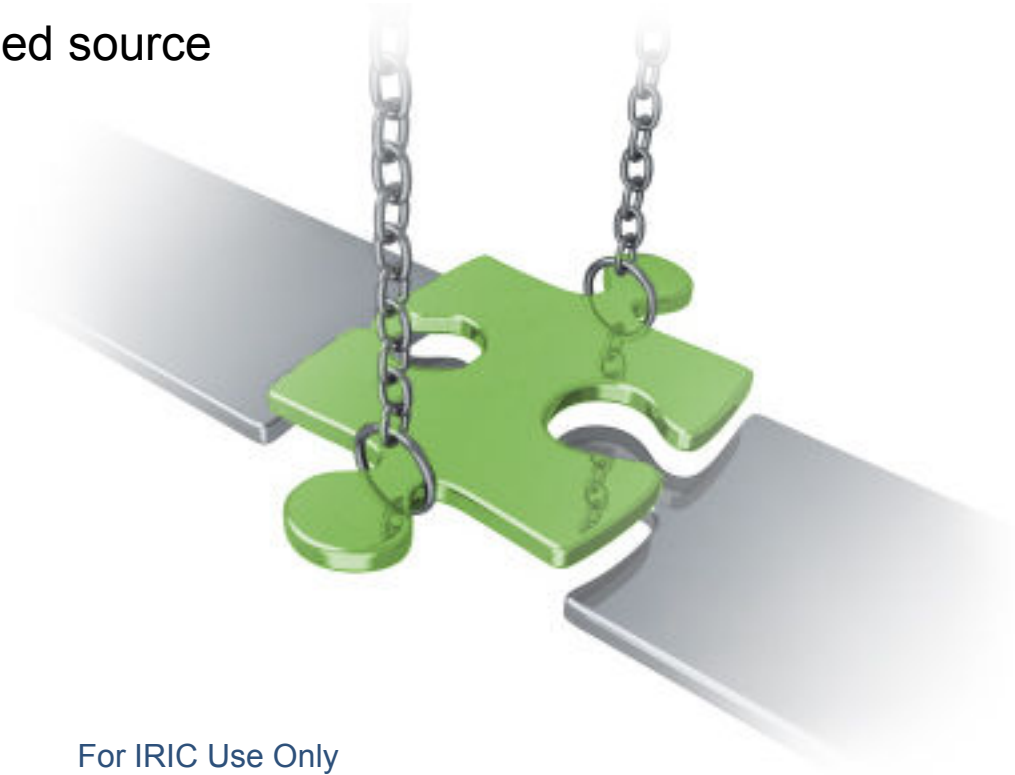
### Vision

Recognized as a Thought Leader by Plan Sponsors, Intermediaries, Recordkeepers, Product Providers and Distributors

# Gap IRIC Fills in the Market



- Institutional Retirement Income not widely understood
- Plan Sponsors are skeptical
- Plan Sponsors need unbiased source
- IRIC fills the gap
  - [www.ircouncil.org](http://www.ircouncil.org)



# Update from Washington



- Retirement Income hearings were held by the Department of Labor and The Treasury Department in September 2010
  - Over 40 organizations gave testimony over two days
  - Focus was on guaranteed retirement income solutions
- Issues discussed in testimony included:
  - Fiduciary concerns on the part of the plan sponsor – Requesting safe harbor relief in the selection process for an annuity provider
  - Clarification of participant communication and impact on Interpretive Bulletin 96-1
  - Coverage of guaranteed income products by state insurance guarantees in the event of a insurer default
  - Use of guaranteed income products as a plan default
  - Portability issues surrounding guaranteed income products when changing recordkeepers

# Why Plan Sponsors Should Consider Institutional Retirement Income Solutions



- Help employees achieve retirement income security through their retirement plan
  - Employer based solutions offer familiarity, ease of use, and lower costs
- Employers are uniquely positioned to influence employees
  - Employees expect employers to provide “smart” benefit choices
  - Plan design, options, and defaults send powerful messages
- Reputational risk when retirees become destitute
  - 54% of workers who took a lump sum in 2003 spent it all within 3 years\*
- Reduce threat of congressional mandates

\* AARP Public Policy Institute Report, 2006

# Retirement Income Solutions Current Generation



- Status of product offerings
  - New products have entered the market
    - Guaranteed
    - Non-Guaranteed (Financial Engines, GuidedChoice)
  - Other product offerings have been pulled from the market
  - Development of multi insurance and hybrid solutions
- Market volatility has caused a re-design of the variable annuity products
- Open architecture investment management solutions
- Retirement Income solutions are being considered for use as a QDIA

# Types of Guaranteed Institutional Retirement Income Solutions



## ***Guaranteed retirement income solutions fit into one of six categories:***

- In-plan immediate annuities
- In-plan deferred fixed annuities
- In-plan guaranteed minimum withdrawal benefits
- In-plan guaranteed minimum income benefits
- Out-of-plan immediate annuity rollover platforms
- Out-of-plan guaranteed minimum withdrawal benefits

# Types of Guaranteed Institutional Retirement Income Solutions



## ***In-plan immediate annuities:***

- Provides a guaranteed income for life of the participant
- Plan Sponsor selects the insurance provider, minimal impact on recordkeeper
- Available as a distribution option to participant
- Single premium purchase subject to spot interest rate risk
- Limited usage among plan sponsors
  - 14% of plans offer today\*
  - 1% of participants who have the option use it\*
- Many plan sponsors have worked to eliminate the option since mid-1980's in effort to simplify distribution options and lower costs
- Option is required to be offered by money purchase pension plans
- Product available from dozens of insurance companies

\* Hewitt Associates, "Survey Findings: Trends and Experiences in 401(k) Plans", 2009

# Types of Guaranteed Institutional Retirement Income Solutions



## ***In-plan deferred fixed annuities:***

- Provides a guaranteed income for life of the participant
- Plan Sponsor selects the insurance provider, recordkeeper must be able to support
- Available as an investment option to participant, e.g. participant controls what portion of each contribution is to be directed toward this option
  - Viewed as an asset class similar to Fixed Income
  - Allows for dollar-cost averaging
- Products designed to support liquidity prior to retirement (hardships, loans, termination), but not after retirement
- Participant has no control over how dollars are invested before or after retirement
- Participant elects form of income stream at retirement, with various options
- Annuitization is required once the participant elects to receive retirement income
- Examples: Merrill Lynch Personal Pension Builder (with MetLife), The Harford Lifetime Income

# Types of Guaranteed Institutional Retirement Income Solutions



## ***In-plan guaranteed minimum withdrawal benefits:***

- Provides a guaranteed minimum withdrawal for life of the participant based on a “high water mark” of the account balance
- Plan Sponsor selects the insurance provider(s), recordkeeper must be able to support
- Works like a mutual fund before and after retirement
  - Participant is able to direct investments within the guaranteed funds
  - Participant can transfer out or take a withdrawal from the guaranteed funds at any time but will lose a proportional value of the guarantee
  - No premium purchase or annuitization required
  - Explicit fees are charged to the participant for the insurance option
- Annuitization is not required for the participant to receive retirement income
- Examples: Prudential IncomeFlex, John Hancock Guaranteed Income for Life

# Types of Guaranteed Institutional Retirement Income Solutions



## ***In-plan guaranteed minimum income benefits:***

- Provides a guaranteed minimum income for life for the participant based on the amount of deferred fixed annuity purchased prior to retirement
- Plan Sponsor selects the insurance provider, recordkeeper must be able to support
- Works like a variable annuity with a higher degree of transparency
  - Allows participant/retiree to be partially invested in the market
  - Amount in the balanced fund is always liquid
  - Allows for dollar cost averaging for the purchase of the annuity
- Investment fund(s) which directs a portion of each deposit toward the purchase of a fixed deferred annuity while the remaining deposit is invested in a balanced fund (such as an age-based target date fund)
- Additional distributions may be made from the portion of the account invested in the managed fund; once this account is exhausted, only the minimum will continue to be paid

# Types of Guaranteed Institutional Retirement Income Solutions



## ***Out-of-plan Immediate Annuity Rollover:***

- Similar to in-plan immediate annuity except:
  - Plan Sponsor selects shopping service platform to screen insurers, gather comparative information, obtain quotes, and handle administration
  - Requires minimal involvement of Plan Sponsor and recordkeeper
  - Participant selects insurance provider based on costs and features and can designate some or all of account balance toward annuity purchase
  - Provides comparative information on multiple insurers and products, but can be single-insurer
  - Provides participant institutional pricing
  - Purchase is made after amount of premium has been distributed to IRA, and all subsequent transactions take place through the IRA
  - Single premium purchase subject to spot interest rate risk
  - Example of shopping service platform: Hueler Income Solutions

# Types of Guaranteed Institutional Retirement Income Solutions



## ***Out-of-plan Guaranteed Minimum Withdrawal Benefit:***

- Similar to in-plan minimum withdrawal benefit except:
  - Available as a distribution option to participant
  - Plan Sponsor selects insurance provider which gives participant institutional pricing
  - Requires minimal involvement of recordkeeper
  - Participant rolls over some or all of account balance to IRA
  - “High water mark” established at retirement based on rollover balance (can increase if retiree defers receipt of minimum withdrawal or annual market appreciation is larger than the minimum withdrawal)
  - All subsequent transactions take place through the IRA

# Types of Guaranteed Institutional Retirement Income Solutions



## ***Which type of solution is appropriate depends on priorities of the Plan Sponsor***

- Out-of-plan solutions minimize impact on:
  - ✓ Plan design
  - ✓ Administration
  - ✓ Recordkeeping
  - ✓ Communications
  - ✓ Fiduciary risk
- Relative to comparable in-plan solutions, out-of-plan does not offer protection during accumulation years
- Immediate and deferred annuities are relatively easy to understand, but utilization has historically been low
- GMWBs and GMIBs address some of the complaints about annuities (such as making an irrevocable decision) but are very complex and untested
- Fixed annuities offer a higher payout stream but with limited investment flexibility
- GMWB's offer a potentially lower payout stream but with increased investment flexibility

# Retirement Income Solutions Future Direction



- Continued enhancement of product design
- Consolidation of product offerings in the marketplace
- Enhanced non-insurance products to provide retirement income
- Integration of products with other plan offerings (managed accounts)
- Increased use of middleware products used to integrate the recordkeepers with the product manufacturers – Addresses the portability issue

# Key Considerations for Plan Sponsors



- **Before analyzing any retirement income solution, Plan Sponsors should ask themselves:**

***What is our retirement income strategy for participants in our DC plan?***

- What problem(s) are we trying to solve?
  - Transitioning from a DB plan (enhancing the value of the DC plan)
  - Retaining assets in the plan (in-plan solutions)
  - Declining productivity
  - Large portion of workforce nearing retirement age
  - Improve employees' financial security
- What level of commitment do we have?
  - Simply make it available
  - Actively encourage
  - Achieve meaningful results (high utilization)

# Key Considerations for Plan Sponsors



- How much are we willing to take on?
  - Administration
  - Communication
  - Costs
  - Fiduciary liability
- Approach for adding a retirement income solution
  - When – Does it make sense to offer to participants?
  - What – Fixed or variable solution? Should it be in-plan or out-of-plan?
  - How – What income solution(s) are appropriate for the Plan

# Key Considerations for Plan Sponsors



- Sample Product Specific design issues
  - In-plan or Out-of-Plan
  - Income guarantees and structure
  - User Experience
  - Fee Structure
  - Equity Participation
  - Equity update/downside protection
  - Claims Paying Ability of Insurer/Single vs Multiple Insurer
  - Portability

# Industry Challenges: Plan Sponsors



- Getting them to “own” this problem
  - Competing priorities
  - Satisfied with offering a competitive contribution and standard fund line up
  - Hesitation – fear of being an early adopter, waiting for next generation
- Fiduciary risk → additional safe harbor relief?
- Overcoming the negative association with “annuity” and “insurance”
- Complexity makes it difficult to understand, analyze, evaluate, monitor
  - Need standard benchmarking framework and tools (i.e. Morningstar)
- Implementation hurdles
- Monitoring of participant usage and product impact

# Industry Challenges: Structural



- Single insurer risk
  - Long term commitment – 30-60+ years
  - Weakness in reliability of ratings revealed during recent financial market crisis
- Portability
- Standardization
  - Recordkeeping
  - Communicating
- Methods to benchmark, evaluate and monitor
  - Does not fit neatly into mutual fund model
  - How to measure success
- State insurance laws
- Need for education as opposed to “product push”

# Industry Challenges: Costs



- Typically embedded in returns or guarantees
  - Results in plan participant bearing expense
  - Makes it difficult to compare between a fixed vs. variable solution
  - Transparency is a challenge
- Can include following components:
  - Investment management expense
  - Insurance guarantee
  - Administration (including recordkeeping and communications)
  - Other loads (sales, distribution, product development and support)
- Volatile markets have had an impact on overall pricing of the insurance

# Questions and Answers



*Innovation, Communication, Evaluation*