ERISA Advisory Council Meeting

U.S. Department of Labor

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Actuaries

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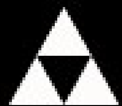
Kenneth A. Kent presentation to the ERISA Advisory Council, U.S. Department of Labor

Retirement Distributions and Options

Actuarial Perspective as a Caveat

- Professionally, pension actuaries are focused on financial risks of retirement systems.
- Pension actuaries typically work with employers on group programs where financial efficiency is derived from pooling risk.
- In retirement, the key risks are investment risk and longevity risk.
- In the areas I have been asked to speak about today – defined contribution plan distribution options – risk pooling is typically lost as both forms of risk are placed in the hands of the individual to manage.



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Actuarial Profession's Concerns about Distributions

- Distributions, whether from defined benefit plans or defined contribution plans, should reflect the nature of the plan objectives.
- Participants should understand the risks and implications of their choices.
- Default elections typically are the most prevalent choice unless there is economic benefit to select against the sponsor.
- Incentives that drive economic choice should be level and fair between alternatives.

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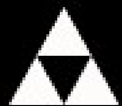
Retirement security and retirement savings may not mean the same thing.

- Fundamental to any society is the overriding concept of pooling our resources and managing our risks as a community.
- There are risks in retiring that many Americans are unable to manage on their own, those being longevity and investment risk.
- Different benefit structures obviously are intended to either provide security for managing these risks or leave full responsibility up to the individual in managing their savings.
- If pooled risk is an important financial tool then incentives for individuals to remove themselves from risk pooling and manage their own risk ultimately will increase society's costs.



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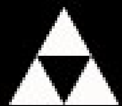
Therefore, to address financial security of retirees, the following must be taken into account:

- Protection against investment and longevity risk, through pooling resources, is an important component of cost management.
- Distribution options should focus on these concepts – as a form of insurance.
- Balance between defined contribution and defined benefit plans is an important component.



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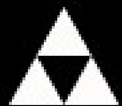
"Participants should understand the risks and implications of their choices."

It is encouraging that as part of discussions about individual accounts for Social Security reform, people are weighing in favor of the defined benefit aspect of the program.

The risk of living off of savings, whether through personal savings or through a defined contribution plan account balance, or the Bush administration's other proposed account-based savings programs, will rely on one of two alternative behaviors for most Americans:

- Either they will continue to feel obligated to save during retirement and live below their means; or
- They will overestimate their investment ability and/or underestimate their longevity and run out of funds.

The opportunities for individuals to protect themselves against either outcome are expensive today.



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What we have learned is that most employees accept what has been given to them and are resistant to change.

Therefore, if a plan has a default option it is the one most prevalent.

However, when given a choice between cash now or periodic payments – as in the case of choosing a lump sum today over an annuity from a defined benefit plan that provides the option – employees tend to overcome resistance to change the default and elect cash. This often is done without consideration of the trade-off risk.

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Part of the reality here is that the lump sum option first became popular for defined benefit plans in the 90's when retirees were choosing to invest on their own to capture the higher rates of return.

Now participants take lump sums because with low mandated interest rates in calculating lump sums, they receive a much higher value – even though these values are equivalent to the annuity on which they are based.

The problem facing retirees is that there is no perceived market alternative to individual savings once they have cashed in their individual account or lump sum to mitigate investment and longevity risk.

The problem facing employers is their plans have been subject to anti-selection through decline in interests rates that was unanticipated when they added lump sum provisions.

The problem facing policy makers is no one wants to take a benefit option away from participants even as lump sums contribute to the erosion of funded status.

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"Incentives that drive economic choice should be level and fair between alternatives."

Legislative proposals have been suggested to encourage annuitization of savings through tax incentives.

This is an important initiative in as much as when risk is transferred to individuals who may be incapable of fully assuming them, we potentially pass these risks on to future generations if the individual fails.

However, many of the proposals are structured to provide the tax relief that ultimately is disproportionately for the benefit of higher paid individual.

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The challenges with such proposals include the following:

- They do not target lower-paid individuals because of the tax incentive structure.
- To broaden a tax incentives can be expensive.
- Most proposals tend to create another bias against plans that provide annuities as a standard form of benefit.
- They discourage retention/adoption of defined benefit plans.

Most proposals are put forth to give tax relief on income derived from savings converted to annuities.

Tax incentives should include distributions from defined benefit plans.

Incentives, if provided, should be for all annuity income provided by employer sponsored plans as well as through individual annuitization.

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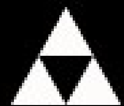
How Hard a Line Should Be Taken?

If the concern is that most employees, at best, can anticipate being covered by a defined contribution plan as the only additional form of retirement income beyond Social Security, should annuities be mandated as the standard form of benefit?

This would meet a fundamental societal need in securing retirement income for the elderly.

But the perception of value of an annuity over lump sums or account balances:

- Is not likely to change under the current low interest rate environment;
- And the economic incentives to motivate annuitization if applied uniformly may be too expensive.



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Phased Retirement – Distribution Options

- There is a need for simple rules that allow for in-service commencement of benefits.
- The payout alternative should, at a minimum, be of equivalent value.
- Communications are essential but should not be over-burdensome and technical.
- Rules under defined contribution and defined benefit plans should be the same as they relate to eligibility for benefit commencement.

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Encouraging a Simplified Defined Benefit Structure May Be More Advantageous.

If you can define a safe-harbor rule which allows adoption of defined benefit plans that are as easy as those for defined contribution plans, what would be needed?

- Limited choice of long-term assumptions based more on asset liability matching than the current balanced portfolio;
- Benefit targets designed using a bond market based investment assumption within expense levels anticipated by sponsors for the long-term;
- Mortality assumptions that include projected improvements;
- Benefit structure that addresses salary growth; and
- Tax incentives on annuities distributions at long-term capital gains rates.

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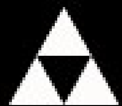
What is Achievable with a Safe Harbor Defined Benefit Plan?

- ✓ Opportunity to hedge all risks though a group annuity contract with similar assumptions or through investment selection
- ✓ Predictable low-cost volatility
- ✓ Emergence of employer-sponsored plans
- ✓ Opportunity for more simplified certification procedures
- ✓ Broader coverage.



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What You Sacrifice

- Benefits will be less than in the past:
  - Bottom line is benefits were valued as less expensive but funding was riskier than realized in the 1990s
  - Employers did not perceive the level of risk during high market return
  - Reestablishing a lower risk model is needed.
- Giving up the lump sum option and individual's control over investments.

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Conclusion

The Pension Practice Council of the ***American Academy of Actuaries*** asks you to consider the following while looking to enhance financial security through defined contribution plan distributions:

- The potential solution already is out there in the form of defined benefit plans.
- Tax incentives for annuitization should universally apply.
- Default options are effective tools, provided they are perceived as economically equivalent.

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