

Retirees Have Choices and Need Flexibility, Not Mandates, in Retirement Planning

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By Paul Schott Stevens

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With the leading edge of the Baby Boomers beginning to retire and the overall success of the defined contribution (DC) retirement system in allowing participants to build retirement assets, policymakers and retirees are focusing on a new issue: how to manage one's retirement assets to last a lifetime.

As lawmakers and regulators consider lifetime income policy, it is important to understand how retirees spend their retirement savings and why. Retirement savers have multiple lifetime income options available to them, and the Investment Company Institute's investor research shows that DC plan participants can and largely do make sound choices among the options they have available. Research also shows that retirees have widely varying needs for income and assets, clearly indicating that there is no one-size-fits all solution when it comes to retirement planning.

Thus, government policy should not constrict or distort the market through mandates or incentives that favor one product or approach over others. The government can best help Americans saving for retirement by providing quality education and information about retirement asset distribution at and through retirement.

Ways to Manage Retirement Assets

The private DC retirement system clearly has been successful in helping ordinary Americans accumulate assets for retirement. As of year-end 2009, Americans held \$4.1 trillion in DC plans and another \$4.2 trillion in individual retirement accounts (IRAs), largely funded by rollovers from employer-based plans. Taken together, that means a significant fraction of Americans' retirement assets can be traced to the DC system, even though its core feature—the tax code Section 401(k) plan—is less than 30 years old. DC plans, and 401(k)s in particular, have grown rapidly thanks to the combined efforts of employers, employees, service and investment providers, and government to create a flexible, innovative system that responds to the needs of both workers and workplaces in a rapidly evolving financial landscape.

Now, as the leading edge of the first “401(k) generation” moves toward retirement, the policymakers, individuals, and businesses that fostered the DC system are looking at a new question: What can be done to help Americans manage these DC and IRA assets in retirement? Recently, the Department of Labor enriched the discussion surrounding this question—it received [more than 750 comments](#) from the public (85 PBD, 5/5/10; 37 BPR 1083, 5/11/10) about “what steps to take to enhance retirement security in employer-sponsored retirement plans through lifetime annuities or other arrangements that provide a stream of income after retiring.”

Retirees face the risk that they will outlive their financial resources—longevity risk. But they face other risks as well—the corrosive effect of inflation, the volatility of financial markets, credit and other risks associated with specific financial decisions, unforeseen health problems or other emergency expenses. To address certain of these risks, some propose that government steer workers to specific products and encourage standard paths for all retirees. Not infrequently, these proposals are premised on the notion that savers and retirees are incapable of making good financial decisions for themselves.

ICI's extensive research on retirement plan participants is instructive on these points. It shows that workers and retirees can and largely do make sound choices among the options they have available. It also underscores the fact that retirees have a wide range of

objectives to meet with their retirement assets—ruling out any one type of distribution method as the best choice for all or even most retirees. And in our surveys, Americans are overwhelmingly opposed to proposals that would cost them control over their retirement assets.

Fortunately, retirees today have a variety of options for managing their financial resources, and new approaches continue to be developed. Public policy should aim to foster innovation and ensure that participants have the education and information they need to make informed choices on how best to manage their assets and meet the challenges of funding retirement. It should not constrict or skew the market through mandates or incentives that favor one product or approach over others.

Participants' Spending of Retirement Assets

ICI research shows that retirees spend down assets in their retirement plans carefully, consult multiple sources of information, and are concerned about risks in addition to longevity.

Survey of Recent Retirees

In late 2007, [ICI surveyed recent retirees](#) who had actively participated in DC plans about how they used plan proceeds at retirement. Most retirees chose an option that preserved their assets for use in retirement, such as a reinvested lump sum, installment payments, annuities, or leaving the balance in the employer's plan. Only 7 percent of the value of lump-sum distributions were cashed out (and possibly spent). Since lump sums represented about half of total distributions, the amount cashed out represented only 3 percent of all accumulated DC account balances.

Participants' actions indicate that they do not take these decisions lightly. In making their distribution decision, retirees with a choice among options often consulted multiple sources of information. Forty-two percent indicated they sought advice from a professional financial adviser that they found on their own. Three in 10 indicated they attended a seminar or workshop offered by their employer; 29 percent reviewed printed materials provided by their employer; and 13 percent used a professional financial adviser provided by their employer. Fifteen percent sought advice from a publication and 10 percent considered information provided in mutual fund company materials.

Survey of IRA-Owning Households

A large portion of the assets distributed from employer plans are rolled over into IRAs. In [a separate survey of IRA owners conducted in May 2009](#), ICI found that households that own IRAs tend to manage their IRA assets responsibly. The survey found that overall few households withdraw money from their IRAs in any given year, and most withdrawals are related to retirement needs. Of households with traditional IRAs in 2009, about one in five reported taking a withdrawal in tax year 2008. Withdrawals were typically modest: the median annual withdrawal was \$6,000 and nearly one-third of withdrawals totaled less than \$2,500.

IRA owners reported a variety of reasons for making withdrawals, which highlighted retirees' differing needs and desire for flexibility to manage their own funds. For instance, among traditional IRA-owning households that took withdrawals where either the head or spouse was retired, the most commonly cited use of funds was payment of living expenses. However, respondents also cited healthcare and emergency expenses, as well as home purchase, repair, or remodeling, as other ways they used withdrawals. Survey results also reflected the fact that IRA-owning households that took withdrawals in tax year 2008 usually consulted outside sources in deciding how much to withdraw.

Multiple Lifetime Income Options

DC plan participants and IRA owners who seek to obtain a lifetime stream of income in retirement have a range of options. Numerous products and strategies are available to meet individuals' varying needs. Among these are installment payments and systematic withdrawal plans, life expectancy withdrawals, annuities, longevity insurance, and new products such as managed payout funds.

With installment payments, which are now common in DC plans, a participant selects a period of years over which his or her account balance is to be distributed (typically 10 or 20 years). In a systematic withdrawal plan (SWP), a participant or IRA owner elects to receive a specified percentage or amount from the account on an established schedule.

Life expectancy withdrawals similarly are designed to ensure the retiree will not exhaust his or her savings before death. Here, withdrawals are based on remaining life expectancy, much like a required minimum distribution calculation in an IRA or qualified plan.

Insurance company annuities are another method of generating lifetime income from the participant's retirement accounts. In the insurance context, an annuity is a financial contract between an individual and an insurance company. The individual agrees to pay the insurance company premiums in return for guaranteed payments, typically for the remaining life of the individual. The purest form is a fixed immediate life annuity, but many products labeled as an annuity include other features like guaranteed minimum withdrawal

benefits and death benefits.

Longevity insurance is a type of single-premium deferred life annuity. It provides a floor beneath which income of a long-lived retiree cannot fall regardless of how long he or she lives, and it can be combined with either installments or SWPs. At a certain age—say 65—an investor would purchase a life annuity that does not begin to make payments until a later date—for example, when the individual reaches age 85.

Managed payout products have come to market to address retirement income needs. A managed payout fund typically is a mutual fund managed with sophisticated payout designs meant to provide a predictable monthly check. It is essentially a vehicle for both investment and payment.

Delaying Social Security benefits is another strategy that may be advantageous for individuals who have other assets on which to live pending receipt of these benefits.

Government Policy Should Be Neutral

Tradeoffs are involved in any choice of retirement income product or solution. Each of the various distribution forms described above has advantages and disadvantages.

While retirees face universal risks—such as longevity risk, market volatility, and inflation—each retiree also must take into account personal circumstances, such as varying sources of income, health status and life expectancy, the need to have cash available for emergencies, goals in retirement, and interest in leaving assets to heirs. As a result, the decision on whether an annuity or other lifetime income product is appropriate is highly personal. There is no “one-size-fits-all” solution and the government cannot and should not posit that one approach is preferable for all or even a majority of Americans.

Not surprisingly, ICI research shows that Americans overwhelmingly oppose being required to annuitize some portion of their 401(k) plan accounts. In a [year-end 2009 survey of American households](#), respondents asked about potential policy changes revealed a very strong preference to preserve retirement account features and flexibility: 96 percent of all U.S. households indicated they did not want the government to take away retirees' ability to make decisions about retirement assets and income. Seven in 10 U.S. households in the survey indicated they opposed the government requiring retirees to trade a portion of their retirement plan accounts for a fair contract that promises to pay income for life, whether from the government or an insurance company.

Automating Choices Would Be Inappropriate

Some proposals aimed at increasing annuitization, such as making an annuity the automatic default distribution option, seek to use inertia to result in allegedly more rational choices. The trend of automation works well in the accumulation phase of employer-sponsored retirement savings, but automation is inappropriate in the distribution phase.

Today's automated plan features are simple, easy to understand, and easy to apply to a whole participant population. The goal of automatic enrollment in 401(k) plans is to kick-start the retirement savings process. If one can afford to save for retirement, it is generally a good idea to participate in one's plan and to increase the level of contribution over time. The basic principles of investing (like diversification) apply to most all retirement savers. Most importantly, for a participant who does not feel that the automatic choices (whether the default contribution rate or the default investment) are right for him or her, undoing the automatic election is easy and does not involve significant cost.

Automation of the retirement income decision is less advantageous. In the distribution phase, the needs of individuals tend to be more idiosyncratic—affected by health status, family situation, personal financial goals, other sources of income (e.g., Social Security and defined benefit pension income) and other factors. The choice of a spend-down product or approach is an individual decision. For these reasons, a plan sponsor who wants to designate a default distribution option may want to select one that participants can undo easily and without great expense.

In any case, the decision to use automatic accumulation features such as automatic enrollment and escalation in plans rests with plan sponsors. Likewise, the decision on what distribution option will be the default also should rest with plan sponsors.

Quality Education and Information Needed

Because there is no one-size-fits-all solution in the distribution phase, information, education, and advice are key to equipping Americans to manage their assets in retirement. Participants need to understand the objectives of the various distribution options available to them both inside and outside the plan, how those options address their individual needs, the limitations of each option, and product fees and expenses.

Need for Agency Guidance

The Department of Labor (DOL) and Internal Revenue Service (IRS) should tailor their policies to encourage education and advice programs in the distribution phase. The DOL could undertake a number of initiatives, including:

- providing guidance that makes clear that plan sponsors and service providers may convey the general advantages and disadvantages of various distribution forms without triggering fiduciary liability;
- completing its project to implement the Pension Protection Act investment advice provision, which is designed to expand opportunities to provide advice within 401(k) plans and IRAs; and
- providing guidance to plan sponsors on the appropriate use of plan assets to pay for efforts to educate participants about lifetime income and other distribution options, whether inside or outside of the plan.

Promoting Public- and Private-Sector Education

DOL and IRS should become catalysts for partnerships among financial firms, non-profit organizations, and the government to develop and publicize an educational campaign to help participants with distribution decisions at retirement.

For example, public- and private-sector stakeholders could work together to develop effective educational tools that meet the needs of those entering retirement. These materials would be most useful if they are made prominent and easily accessible through use of technology and new media, employer-offered computer courses, or social networking sites.

Policymakers may want to consider other steps, as well, including:

- offering individuals and employers incentives to participate in or offer a financial education curriculum, and
- supporting efforts to make Americans aware of the potential advantages – in terms of monthly income – of delaying the date at which they begin taking Social Security.

The DOL and IRS also should work with other interested regulatory agencies to assist and protect retirement savers. For example, this effort could be modeled on the work done by the Securities and Exchange Commission, the North American Securities Administrators Association, and the Financial Industry Regulatory Authority to develop extensive online [resources for senior citizens](#) to help address the problem of [senior fraud](#). The DOL and IRS, as retirement plan regulators, could join forces to expand these tools to protect and educate retirement investors in general.

Conclusion

The needs of retirees vary widely depending on personal circumstances. While many different investment and distribution products and strategies are offered to meet those needs, government policy should not favor one approach over another. The choice of any one product, including a lifetime income annuity, comes with advantages and disadvantages. The role of government should be to promote access to education and information to help individuals make informed decisions. ICI will continue to work with policymakers to find the best solutions to help Americans save for retirement and manage their assets into and through retirement.

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