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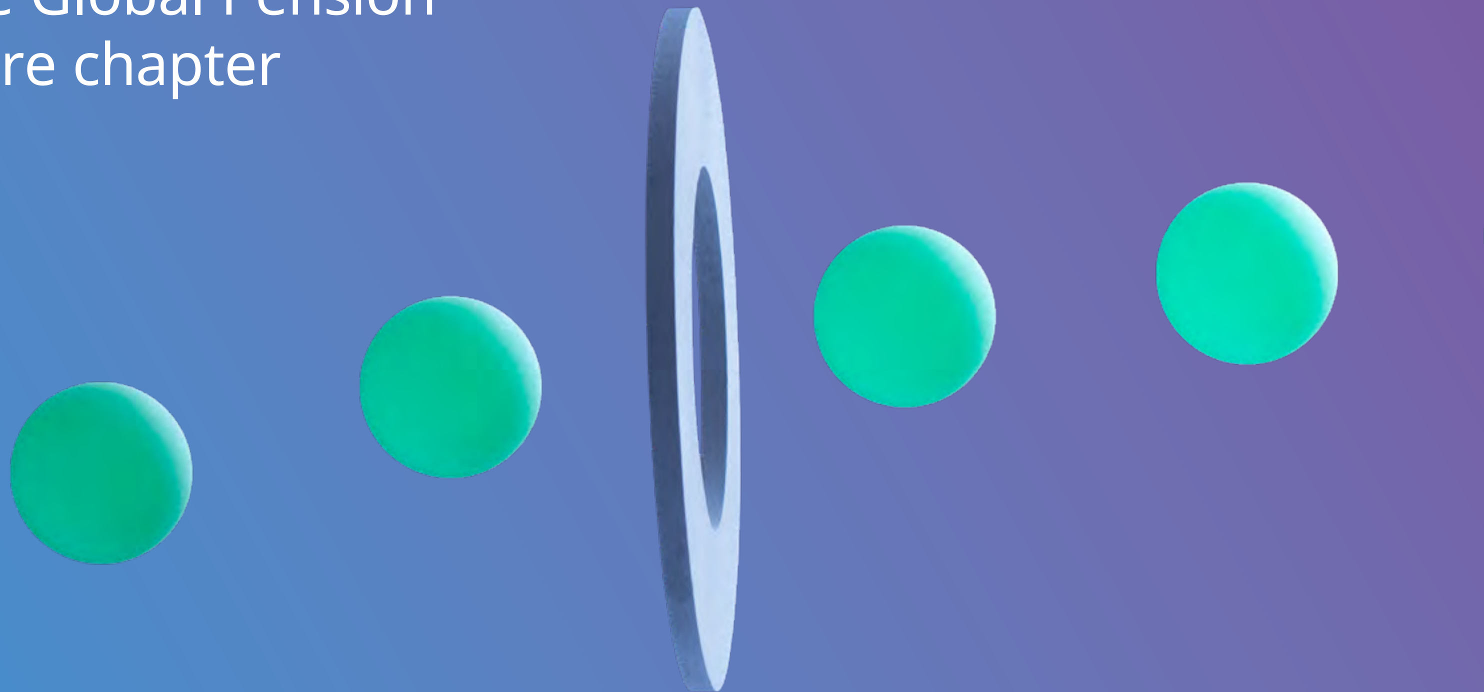
Converting defined contribution benefits into better outcomes for retirees

Mercer CFA Institute Global Pension Index 2022 — Feature chapter



Feature chapter:
Converting defined contribution benefits into better outcomes for retirees

The provision of retirement income to individuals and households has changed dramatically in many countries during the past two or three decades. This significant trend toward DC plans is not going to reverse and will continue to affect an increasing number of retirees in years to come.

A challenging DC equation

- **Employers are stepping away from defined benefit (DB) pension plans.**
- **Individuals are now bearing all the risks.**
- **Retirees are receiving lump sums, not pensions.**
- **Many households are not equipped to make financial decisions.**

Historically, most pension arrangements in developed economies (including social security and occupational DB schemes) provided a regular income payment to retirees for life, and often their partner's life, too. In brief, retirees received a regular pension that was often indexed to inflation.

Employer sponsors, who previously supported the DB pensions, have stepped away from accepting any risks or providing any financial guarantee. Though government pensions have continued, the global shift to DC occupational pension plans has significantly changed the equation for retirees. Unlike DB pension plans, DC plans provide the individual with a lump-sum benefit (or pension pot) at retirement. All the risks during the years before and after retirement are transferred to the individual.

Many governments have also reviewed, or are considering reviewing, their level of support of the government pension to ensure its sustainability over the longer term. These reviews need to take into account increasing life expectancies, the impact of the aging population and the increasing level of government debt, and perhaps lead to increases in the "official" retirement age or downward adjustments to the benefit formula used.

The overall result is that many future retirees will no longer be able to rely on significant financial support from their previous employers and/or the government in times of financial stress. Individual responsibility has increased materially.

Yet, most individuals and households are not prepared to make the necessary financial decisions at retirement and to maximize their value from the available DC pension pot. It is a very difficult situation, particularly as the post-retirement years require much more complex decisions than the pre-retirement years when most individuals receive a relatively stable wage or salary and the primary purpose of the pension arrangements is to invest the funds. Of course, it can be even more difficult for those in the informal or "gig" labor force.

William Sharpe, the Nobel Prize winning economist, acknowledges there is no easy answer to all the decisions that are necessary in "knowing how to strike a balance between having enough income to meet your current needs (in retirement) … and having enough to get you through your lifetime." He has called it the "nastiest, hardest problem in finance."[1] Nevertheless, the problem must be tackled so retirees can have a dignified retirement with both confidence and financial security.

This chapter discusses the needs and desires of retirees, the questions they face, the range of products available, various approaches currently in use around the world, and the options for governments, policymakers and the pension industry to consider in achieving the best outcomes for future retirees.

[1] Max S. "Nobel Prize-Winning Economist on How to Solve the 'Nastiest, Hardest Problem' in Retirement," *Barrons*, 2019, available at www.barrons.com/articles/william-sharpe-how-to-secure-lasting-retirement-income-51573837934.

The needs and desires of retirees

Most retirees wish to maintain their previous living standard in retirement, possibly at a level similar to that experienced in the previous 10 or 20 years. This reflects an important starting point as it means a career-average approach, spanning 40 years or more, is unlikely to reflect the desires of many retirees.

Retirees need to consider the possibility of retirement lasting 30 or more years, which is well beyond the planning horizon for most people. Furthermore, the concept of longevity risk is not well understood or appreciated by most individuals approaching retirement.

What do retirees want?

- Stability
- Sustainability
- Flexibility
- Bequest
- Transparency

Retirees want stability — a regular and reliable income that keeps pace with price inflation. This provides a secure base for their future living standards. There is some debate as to whether full-price inflation is needed, as several studies suggest that retired households actually decrease their consumption over time. Although health-related expenditure may increase with age, some other expenditures, such as travel, decrease, leading to an overall reduction in real expenditure.

However, Chen and Munnell suggest wealthier and healthier households have relatively flat consumption paths, whereas households with less wealth or poorer health at retirement have declining consumption during retirement.[2] In reality, these differences may not reflect the preferred paths of retirees, if additional wealth or better health existed. Therefore, the objective should be to enable retirees to maintain their living standards throughout retirement.

Retirees want sustainability — that is, income that does not run out, whatever the future may hold. Although most retirees will be unaware of their life expectancy (which, after all, is only an average number), they are aware they do not know their date of death. Or, to put it another way, how long does the income need to last? A related risk is that poor decisions, economic conditions or a fall in asset values may reduce the real value of the underlying pension pot faster than expected. The importance of these risks for each retiree is also affected by the size and characteristics of government support available in the future.

Retirees want flexibility – that is, to be able to access some capital or a “rainy day” fund — unexpected costs occur, and retirees want to be able to meet them. The extent of these capital needs, which could relate to significant medical costs or pharmaceuticals, necessary refurbishment of the home to accommodate reducing mobility or the costs associated with aged care, will vary considerably between individuals. It will also depend on the extent to which government assistance is available to meet such costs. When government funding is available, it is also important that retirees fully appreciate its availability.

Some retirees wish to leave a bequest. On the other hand, “The intra-household bequest is important … but not the intended bequest motive. This suggests that people save for unexpected expenses and to financially protect their partner as a surviving spouse but are less concerned about the distant future.”[3]

Nevertheless, the combination of a “rainy day” fund and a mild bequest motive means that many retirees wish to preserve some of their pension pot for the future. That is, they may use some of it (if needed) or leave it to their children or favorite charity.

Finally, retirees want transparency. Retirees need to know the fees, any taxation implications and the possible outcomes of various options. As costs are normally disclosed during the accumulation period of DC pension plans, future costs should also be disclosed in respect of retirement products.

[2] Chen A, Munnell AH. “Do retirees want to consume more, less, or the same as they age?” Center for Retirement Research at Boston College, 2021, available at https://crr.bc.edu/briefs/do-retirees-want-to-consume-more-less-or-the-same-as-they-age
[3] Alonso-Garcia J, Bateman H, Bonekamp J, et al. “Saving preferences after retirement,” *Journal of Economic Behavior and Organization*, 198 (2022), pp. 409–433.

Impact of moving from DB to DC

The move from DB to DC arrangements allows DC plan members to view their accumulated balance and investments through their regular statement, from the plan's website or through the plan's app. Indeed, some governments even encourage members to consider the DC balance as "their money." This is very different from DB plans, for which members have a promise that, in some cases, can be difficult to understand.

This different approach has also led to the more engaged DC members wanting increased control over their investments, which feeds into their decisions as they approach retirement. For example, if a DC pension plan member is able to select their investment strategy and, in some cases, even select their equity investments before retirement, we can reasonably expect that such freedom will continue when the individual retirees. This is quite different from a lifetime annuity, for which the member is not involved in any investment decisions.

However, although some DC members are more engaged, many DC members remain disengaged and have very limited understanding, both before and after retirement. These members are likely to rely on default arrangements.

Another important outcome of the increasing dominance of DC pension plans is that more plan members have become accustomed to market volatility. During their working years, they have seen the value of their account balance move up and down with financial markets. Therefore, as they move into retirement, they may expect similar outcomes and thereby more readily accept some variability in outcomes. In fact, evidence shows that some retirees will adjust their expenditure in line with the markets. That is, like all demographic groups, during periods of financial uncertainty they will spend less and cut back on some expenditure[4] ; for example, in years of market decline, the retiree may decide to take a local holiday instead of going further afield. In fact, such belt-tightening is consistent with some financial advice when markets are performing poorly.[5]

In summary, the desires of retirees are not all the same and vary considerably. This outcome suggests that a single product does not achieve the most desirable outcome for all retirees. Some flexibility is desirable.

[4] Probasco J. "A Decade Later: How the Financial Crisis Affected Seniors," Investopedia, 2022
[5] Morgan Stanley. "Retirement Income in Volatile Markets," *On Retirement*, 2019.

Questions that retires need to answer

Retirees (and hence product providers and financial advisors) need to consider many issues when deciding the most appropriate portfolio of retirement products.

- **What is the minimum level of income?**
- **What is the likely period of retirement?**
- **What is the retiree's risk profile?**
- **Does the retiree have any significant debt?**
- **Are there any ongoing decisions?**

As suggested above, the main objective for most individuals and households approaching retirement is to maintain their standard of living. To achieve the best outcome, the following questions need to be asked:

- **What is the minimum level of income required to maintain their standard of living?** This should allow for any partner's income, any government pension, any income from part-time work and any other income from outside the pension plan. In addition, if the retiree is a homeowner, this could include income from an equity release arrangement in the future. This can be important for many households in developed economies when the family home can be worth much more than the pension pot at retirement. Alternatively, if the retiree is renting their home, the future levels of rent can be a very significant cost.

- **What is the likely period of retirement?** Of course, this is unknown; however, it will depend on the actual retirement age, the health and the lifestyle of the individual and any partner. We should also note that mortality rates and therefore life expectancies vary by socioeconomic class. Given the retirement period is unknown, it is wise to consider the life expectancy of their individual and their partner, and add at least five years to any figure that may be used.

- **What is the retiree's risk profile?** That is, the extent to which some level of "guaranteed income" is desirable or, indeed, a requirement. Of course, whenever there is a guarantee, a cost is included in the price of the product, which is often implied rather than explicit. Alternatively, the retiree may be willing to "ride the markets" and live with the consequences. To express that another way, how perturbed would the retiree be if their income or accumulated benefit dropped in value by 5%, 10% or 20%?

- **Does the retiree have any significant debt?** (For example, a mortgage or credit card debt.) Members of DC plans often intend to use part of their pension pot to repay any debts and so begin retirement debt-free. Although this may not have been the original purpose of pensions, such payment removes future repayments and thereby simplifies financial planning for retirement.

- **Are there any ongoing decisions required in the future?** One's cognitive ability declines with age, and it is therefore unreasonable to expect retirees in their 80s and 90s to continue to make key financial decisions. Although a "set and forget" approach for 30 years is not necessarily the best approach, nor is a complex arrangement that includes many components and requires ongoing decisions. Simplicity has a huge advantage.

These questions have no single answers, and they will change during the period of retirement. Nevertheless, consideration of these and similar issues should help pension plans develop the most appropriate set of products for their retirees.

The products available

In many cases, a single product will not deliver the most desirable outcome. Rather, a hybrid arrangement including some of the following products may be the best way forward for using the individual's DC pension pot.

Lump-sum payment

The payment of a lump sum at retirement is relatively simple and provides retirees with the opportunity to pay off debt and set themselves up for retirement, although there may be tax consequences. It also requires the retiree to make investment and spending decisions and provides no longevity protection. As Antolin notes, "Few retirees are really prepared to 'self-annuitize' as they lack appropriate financial skills and discipline."[6]

Programmed withdrawal

These arrangements offer greater flexibility than an annuity and can deliver a higher investment return as no guarantee is present. However, they are subject to the fluctuations of the financial markets and the money can run out. It has also been observed that in the absence of any longevity protection or well-designed minimum drawdown requirements, some retirees withdraw their funds at an overly cautious rate, thereby reducing their standard of living and leaving a larger than intended bequest.[7] These arrangements can also include a bucketing approach with different asset classes in different buckets.

Immediate annuity

An immediate annuity offered by a life insurance company provides regular income for life (which may also include their partner's life) and can provide a good base for the necessities of life. However, the individual forgoes any control and normally locks in the current price (that is, linked to current interest rates) for the rest of their life. Market-linked (or variable) annuities are also available for which the level of income is affected by the financial markets. Whatever the actual design of the annuity, the pooling of longevity risk provides a more efficient outcome than self-annuitization. Yet, in many markets, the annuity puzzle remains and products, which have theoretical appeal, do not receive broad market acceptance.

Collective pooled arrangements

An alternative to an annuity, with a partial or full guarantee, is a collective pooled arrangement whereby the income generated will depend on the investment and mortality experience of the pool of participants. Although such arrangements have the potential to generate higher retirement incomes due to the absence of any guarantee, participants need to be made aware of the inherent uncertainty, as occurs with most variable annuities.

Deferred annuity

A deferred annuity commences at a nominated later age and can also provide longevity protection to the retiree. However, many retirees are reluctant to purchase such a product, as an early death would normally mean limited or no return from the investment. This product may also be less attractive to some insurers as the premium received is reduced, and there is a significant tail risk.

[6] Antolin P, Pugh C, Stewart F. "Forms of Benefit Payments at Retirement," OECD Working Papers on Insurance and Private Pensions, No 26 (2008), OECD publishing.
[7] For example, the Retirement Income Review in Australia found that retirees are generally reluctant to draw down their savings in retirement due to a number of factors including "reluctance to consume funds that are called 'nest eggs', concerns about possible future health and aged care costs, and concerns about outliving savings."

What is the best balance?

The OECD suggests that:

"DC pension plans should provide some level of lifetime income as a default for the pay-out phase, unless other pension arrangements already provide for sufficient lifetime pension payments... Full lump sums should be discouraged in general, except for low account balances or extreme circumstances."[8]

Interestingly, the OECD seems to support a hybrid arrangement with some lifetime income together with other products.

Three national actuarial bodies concluded that:

"There would be value in developing appropriate defaults that allow individuals to access their pensions through an income stream that offers flexibility in their early years of retirement. However in the latter years, they could provide, at a minimum, a structured lifetime payment with the potential for a lifetime income guarantee to protect against their longevity risk."[9]

Again, the conclusion was not a single product, but some combination of flexibility and longevity protection.

[8] OECD. *Recommendations of the council for the good design of defined contribution pension plans*, 2022.
[9] American Academy of Actuaries, Institute and Faculty of Actuaries and Actuaries Institute Australia. *The challenge of longevity risk: Making retirement income last a lifetime*, 2015.

Another example of this hybrid approach is the three objectives of the Retirement Income Covenant recently introduced into legislation in Australia. The objectives are:

- To maximize expected retirement income over the period of retirement
- To manage expected risks to the sustainability and stability of retirement income
- To have flexible access to expected funds

Three systems (Australia, UK and the US) have considerable flexibility and retirees can spend or invest their benefit as they wish. Yet, within each of these systems, there has been recognition that this "freedom" does not necessarily lead to the best outcome for retirees. These governments have recognized that there is a need to help retirees in their decision-making process in the following ways:

Australia: The Federal Government introduced a Retirement Income Covenant from 1 July 2022 that requires plan trustees to develop a retirement income strategy, which addresses how the trustee will assist beneficiaries to achieve and balance the three objectives stated in the covenant, as described above.

UK: The UK Government introduced new regulations to encourage or nudge more pension plan members to make use of the free guidance provided by Pension Wise. These regulations require trustees and providers to refer the member to Pension Wise guidance, explain its nature and purpose and to offer to book an appointment for the member, whenever the member makes an application to access their pension savings.

US: The *SECURE Act*, which was signed into law in December 2019, increases the flexibility of America's pension system in several ways, including a new safe-harbor provision that encourages 401(k) plans to offer annuities by removing the fear of legal liability on employers.

Each of these developments recognizes the need for more flexibility and assistance in systems where the importance of DC plans continue to grow.

Suggestions for policymakers to make a difference

The myriad of risks associated with the provision of private pensions for decades to come is shifting from the employer sponsor to the individual, who now bears all the inflation, investment and longevity risks. These risks can be reduced with some pension products and by means-tested government support available in retirement.

Notwithstanding the different retirement income systems around the world, the significant differences between DB and DC are central to the ongoing communication to plan members, as well as their understanding and decision-making processes in retirement.

DC arrangements need to be more flexible and recognize that the greater heterogeneity between DC pensioners when compared to DB pensioners.

With these differences in mind, we suggest the following principles for the development of retirement products for DC pension plan members who are entitled to receive a lump-sum benefit or pension pot at retirement.

- Members with small pension pots (say, with pots of up to 50% or 75% of the average full-time wage) should be able to take these as a lump-sum benefit. This should not be a requirement, but an option, as it recognizes the relatively significant costs associated with small pensions.
- DC pension plan retirees with pension pots above the minimum should be able to withdraw up to half[10] of their initial pension pot during retirement without significant disincentives. This will provide them with flexibility while also ensuing that at least half of their initial benefit provides regular income.
- At least half[11] of the pension pot should be converted into an income stream that provides regular and relatively stable income, when measured in real terms. The permitted income streams should include an annuity, a pooled arrangement or a programmed withdrawal product, thereby encouraging some flexibility. This income requirement should apply until the total income (including any government pension) reaches the average full-time wage. Once this income threshold is reached, no further requirement is needed because this level of income is sufficient to provide a dignified retirement.

[10] A lower percentage may be appropriate when no government pension is available.
[11] Some flexibility in this percentage may be appropriate to take into account the pension pot of any partner, the health status of the retiree and whether the retiree is a homeowner.

- The actual design of the income stream should not be prescribed to encourage innovation and competition. However, some form of longevity protection should be required, while also recognizing that equity considerations relating to gender, health and socioeconomic class need to be taken into account with the pooling of longevity risk.
- The development of default retirement products, consistent with the above principles, is strongly recommended, as many pension plan members will not be engaged. A limited range of alternative products (for example, with different investment strategies) is appropriate to recognize the different attitudes toward risk among retirees. Some portability between retirement products is also desirable to retain some competition and choice.
- Financial education, guidance and independent limited financial advice should be available to all pension plan members approaching and during retirement, including the availability of digital tools, which can allow for non-pension assets. The broad availability of education, guidance and advice is particularly necessary given the range of financial literacy within the broader coverage of the population with DC pension plans when compared with many other savings and investment products.
- Reforms relating to the conversion of DC pension pots into retirement products should be introduced gradually. A sudden change does not encourage community confidence as many individuals and households make plans as they approach retirement.

The conversion of DC pension pots into appropriate retirement products is gradually emerging around the world, and there is no single or perfect answer. It is much more complex than the provision of DB pensions for the reasons mentioned above. The global pension industry and policymakers need to recognize these issues and develop a range of flexible products and policies to deliver the best possible outcomes for individuals and households who will enter their retirement years in a wide range of financial situations while also facing significant uncertainties.

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