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MEMO

TO: Connecticut Retirement Security Board
DATE: October 30, 2015
FROM: Mercer
SUBJECT: Analysis Regarding Annuitization – Follow up from meeting on October 7

Introduction

Thank you for the opportunity to discuss our "Analysis Regarding Annuitization" paper. The subject of securing retirement income is immensely complex and the perfect retirement income solution across participants remains elusive. Hence this topic is challenging for the Connecticut Retirement Security Board to address within a legislative context. Because the CRSB's primary role is to recommend plan design options to the Legislature, the CRSB does not need to take decisions on detailed implementation options to be offered; however we understand that the Board cannot ignore implementation issues given that whatever recommendations are made to the l Legislature should be implementable.

In this follow–on memorandum, we note the proposed recommendation that we think should be made to the Legislature. We then discuss some key issues that arose in discussions, including:

- The potential role of variable annuities, in particular Guaranteed Minimum Withdrawal Benefit (GMWB) contracts;
- Ways to assist with selecting how much retirement income should be annuitized (reference was made to the frontier developed in the book Pensionize Your Nest Egg);
- Whether the default portfolio should be "Required Minimum Distributions";
- The idea of having a laddered bond portfolio at retirement, allowing the participant to keep the laddered bonds and draw an income, or sell the bonds and buy an annuity given this portfolio would be reasonably well "matched".

Prior recommendations

For completeness we have set out below a summary of what Mercer thinks should be included in a comprehensive retirement income strategy (as set out in our October 1, 2015 Memorandum).

1. **Regarding annuitization**
   a. Make annuitization one component of a retirement income strategy.
   b. Focus the retirement income strategy on the "reduced need for public assistance" objective as well as income in retirement.

2. **Regarding participants**
   a. Frame the Program benefits as a lifetime income benefit by the inclusion of an income

projection not just a wealth accumulation.

b. Provide retirement-focused education to pre-retirees that highlights how a retirement income strategy needs to be tailored to an individual's circumstances and that there is not an ideal 'one size fits all "solution".

c. Do not include a lifetime income solution or a managed account solutions as an investment option (at this stage) in the accumulation phase.

d. Encourage participants to consolidate their retirement assets into this Program, consider facilitating a service that can assist participants in consolidating their retirement assets.

e. Provide assistance that enables retirees to optimize their social security claiming strategy.

f. Provide assistance and guidance on the many key questions that participants face in retirement.

g. Make the default retirement income option Required Minimum Distributions.

h. Make available a simplified retirement income menu comprising:

    i. The ability to make systematic withdrawals; ideally with accompanying retiree statements.

    ii. Access to an annuity exchange for retirees to purchase annuity contracts with all or a portion of their retirement capital.

Addressing the specific questions raised during discussion

The potential role of variable annuities, in particular GMWB contracts

GMWB contracts can be a good compromise and address many participants' needs. In particular they provide the following benefits:

- Income for life and accessible capital giving flexibility to address financial shocks and assuring longevity protection;
- An ability to integrate the product into an accumulation strategy, so everyone would have these contracts when they retire.

These contracts are worthy of further discussion. However, our proposal excluded these options, given two of the legislative goals and objectives:

(1) An increase in access to and enrollment in quality retirement Programs <u>without incurring debts or liabilities to the state.</u> ***(23) Ensuring that any contract entered into by or any obligation of the Program shall not constitute a debt or obligation of the state and the state shall have no obligation to any designated beneficiary or any other person on account of the Program and all amounts obligated to be paid pursuant to the Program shall be limited to amounts available for such obligation***	***In the event that a selected GMWB annuity provider defaults, the Program and the Governing and Managing Bodies could be deemed liable, and potentially the State. This issue could be referred to legal counsel for further investigation and an opinion.***
(7) Low administrative costs that shall be limited to an annual, predetermined percentage of the total Program balance.	***GMWB annuities have a higher cost structure because there are fees for administration, the provision of the guarantee (often 1%+) and potentially an advisor fee. As a result they are not generally considered as "low cost" contracts. Note : we are not expressing an opinion as to whether the cost represents value for money.***

If the CRSB believe that these issues can be overcome, then the CRSB may want to recommend that the Implementing Board consider the other pros and cons of varaible annuities, including GMWB contracts, in more detail.

Assistance with selecting how much retirement income should be annuitized

Mercer fully supports finding tools to help retirees decide how much of their retirement assets should be annuitized. We believe that our following recommendations are consistent with this point:

b. Provide retirement-focused education to pre-retirees that highlights how a retirement income strategy needs to be tailored to an individual's circumstances and that there is not an ideal 'one size fits all "solution".
f. Provide assistance and guidance on the many key questions that participants face in retirement.
h. Make available a simplified retirement income menu comprising: i. The ability to make systematic withdrawals; ideally with accompanying retiree statements. ii. Access to an annuity exchange for retirees to purchase annuity contracts with all or a portion of their retirement capital.

The tool referenced in the meeting proposes a mix between annuities and investment products for an individual. In the specific case, the individual's trade-off balances Retirement Income Sustainability with Expected Financial Legacy (bequest) and results in a product allocation. In considering the needs of likely CRSB participants (likely to be lower paid participants) we suggest that a CRSB recommended model specifically address the needs for an emergency fund. The tool proposed does not explicitly allow for an emergency fund, but potentially this tool could achieve a similar result. This point is certainly something that can be considered when evaluating near-retirement guidance.

We believe that our proposals (b) and (f) totally envisage considering tools and guidance that assist retirees with their retirement product allocation. Interestingly, the Pensionize Your Nest Egg approach and some participant facing tools are offered by one annuity exchange provider (also included in our recommendation (h) above).

Whether the default portfolio should be "Required Minimum Distributions"

In our approach we listed the advantages of this approach as being:

1. The option is easy to reverse, as opposed to locking into a retirement product or annuity;
2. The target date fund can be implemented reasonably consistently with this approach
3. This option provides a very low income (nothing until 71) that hopefully will nudge a retiree into making an active decision
4. The approach ensures legal compliance with RMD requirements.

The third point is key. In our view the vast majority of participants will achieve better retirement outcomes by making an active choice rather than relying on a default retirement income strategy. For example we referenced the significant advantages that can accrue to retirees if they optimize when to take social security.

Although we did not make the point in our previous paper, we also believe that retired individuals should remain involved with active decision-making, since circumstances change and a retirement income strategy should respond to those changes. The need to be involved may become less if an individual annuitizes, but default annuitization has significant problems since the transaction is irreversible and will to some degree create a counterparty credit risk exposure for someone that has not taken an active decision. Punam Keller, Bari Harlam, George Loewenstein and Kevin G. Volpp addressed such a scenario (Keller, Harlam, Loewenstein, & Volpp, 2011) highlighting some limitations of default (opt-out) decisions that included:

> "…because opt-out policies yield decisions through the inaction of the decision-maker, they are less likely to engender the kind of committed follow-up that is often useful when it comes to implementing the decision…. Opt-out is likely to be effective in situations in which there is a single optimal course of action, that most people don't take, and that policymakers are able to identify and favor by making the default. However, when different options are best for different people, or when policymakers cannot be relied upon to make the best option the default, then opt-out will be less beneficial and even potentially destructive."

Both of the above limitations are a genuine concern with retirement income strategies. The preferred retirement income strategy is unique to each individual (or at least groups of individuals), so there is no "one size fits all" solution. Additionally, retirement income strategies require adaptation and revision over time, as people's lives change.

Keller et al propose "Enhanced Active Choice" where one "advantages the option preferred by the communicator by highlighting losses incumbent in the non-preferred alternative". Hence our recommendations (in particular b. and f.) set out below:

b. Provide retirement-focused education to pre-retirees that highlights how a retirement income strategy needs to be tailored to an individual's circumstances and that there is not an ideal 'one size fits all " solution.

f. Provide assistance and guidance on the many key questions that participants face in retirement.

h. Make available a simplified retirement income menu comprising:
   i. The ability to make systematic withdrawals; ideally with accompanying retiree statements.
   ii. Access to an annuity exchange for retirees to purchase annuity contracts with all or a portion of their retirement capital.

Our proposal is that near retirees are made aware of the pros and cons of different approaches, and they will appreciate the disadvantages of the default strategy since Required Minimum Distributions will provide a very low income and no income until 71.

Managing Toward a Laddered Bond Portfolio at Retirement.

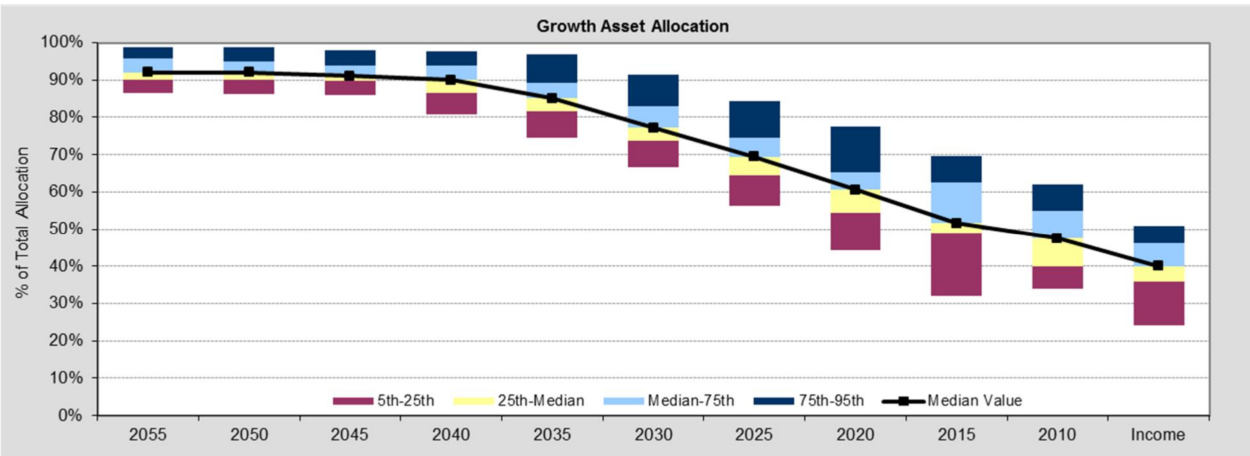
Offering a laddered bond portfolio in retirement is an option that can be considered when the target date fund is being designed. The laddered bond portfolio has the following advantages, specifically the approach:

- minimizes investment volatility, because there is limited equity exposure and bonds are typically less volatile than equities;
- provides reasonable certainty over the expected income in retirement irrespective of movements in asset values;
- provides a recommended income for the retiree (the proceeds of the bond ladder), hence the retiree is far less exposed to "consumption risk" (drawing more money than they can reasonable afford),

The approach also has several disadvantages, specifically:

- A low yield on investment in a low interest rate environment will lead to low income.
- Making this option the default requires a decision with regard to whether to allow deferring social security. In most cases the optimal answer is to defer social security. If one defers social security, then the laddered bond portfolio needs to be structured differently to ensure additional income is available for the period prior to taking social security;
- The laddered bond portfolio can be established for a specified term, but is not suitable for a person living longer than expected. To be effective, the laddered bond portfolio should be recalibrated each year to allow for increased life expectancy;

- A laddered bond portfolio is oriented to a specific retirement date; hence one will need to consider using a single-year target date fund (as opposed to the market norm of five-year target date funds). Single–year target date funds could increase administrative costs, which is something the Program is trying to avoid;
- Having a fully fixed income portfolio at retirement suggests a target date glidepath that reduces to 100% fixed income at retirement. This approach will lead to lower expected accumulations at retirement, since one will reduce equity quicker. This approach will lead to a glidepath that is more conservative than target date funds available in the market. The chart below shows the Growth Asset Allocations of target date funds in Mercer's Target Date Fund Survey as at 31 December 2014.



We understand that a Forward Starting Bond (FSB) has also been suggested as a means to secure retirement income. The greatest challenge is that no such bonds exist; however, there are target payment funds that aim to serve a similar purpose. These funds would allow the Program to set aside some assets to produce income in future years. Again we recommend these options be considered as potential components of the Program's target date fund if such bonds can be made available.

In general, we caution against making the retirement portfolio fully fixed income (potentially through Forward Starting Bonds or laddered bond portfolios). As indicated earlier a fully fixed income portfolio in retirement will likely result in a much more conservative target date fund glidepath, which will in turn produce lower expected outcomes. A trade-off that will need to be resolved is the equity content of the target date fund, which will be influenced by the retirement portfolio. Commercially available target date funds retain a reasonable allocation to equities, which reflects the preference for fiduciaries and individuals to retain some equity exposure. We see a stronger argument for a <u>portion</u> of the portfolios in retirement to contain a partial allocation to options such as Forward Starting Bonds, target payout funds or laddered bond portfolios rather than a full allocation.

Conclusion

Given the feedback we have modified our recommendations with regard to the key elements to be included in a retirement income strategy (modifications are underlined):

1. **Regarding annuitization**
    a. Make annuitization one component of a retirement income strategy.
    b. Focus the retirement income strategy on the “reduced need for public assistance” objective as well as income in retirement i<u>.e. consider the need for retirees to have access to an emergency fund not just income in retirement.</u>

2. **Regarding participants**
    a. Frame the Program benefits as a lifetime income benefit by the inclusion of an income projection not just a wealth accumulation.
    b. Provide retirement-focused education to pre-retirees that highlights how a retirement income strategy needs to be tailored to an individual’s circumstances and that there is not an ideal ‘one size fits all “solution”.
    c. Do not include a lifetime income solution or a managed account solution as an investment option (at this stage) in the accumulation phase.
    d. Encourage participants to consolidate their retirement assets into this Program, consider facilitating a service that can assist participants in consolidating their retirement assets.
    e. Provide assistance that enables retirees to optimize their social security claiming strategy.
    f. Provide assistance and guidance on the many key questions that participants face in retirement.
    g. Make the default retirement income option Required Minimum Distributions<u>, not as a preferred option but with the view to encourage retirees to make an active choice</u>.
    h. Make available a simplified retirement income menu comprising:
        - The ability to make systematic withdrawals; ideally with accompanying retiree statements.
        - Access to an annuity exchange for retirees to purchase annuity contracts with all or a portion of their retirement capital.
    i. <u>Consider the role (full or partial) that can be played by laddered bond portfolios, target payout funds and/or Future Starting Bonds in the design of the Program’s target date fund (sole investment option)</u>

Given that many of these decisions can and should be made during discussions with vendors in the implementation phase, these recommendations can be integrated with a further recommendation to the Legislature that the Governing Body take up the specific decisions during the implementation phase, resulting in the following recommendation:

“The CRSB recommends that the Program be designed to promote maximizing lifetime retirement income by implementing a retirement income strategy with a focus on preventing poverty in retirement. The CRSB recommends that the specific strategy along with its key components and features be determined during the implementation. CRSB further recommends that Legislature require the implementing Board to consider at a minimum the following options in developing a retirement income strategy: a default option aligned with the Required Minimum Distribution requirements; social security optimization guidance and tools; a need for access to emergency funds; annuitized benefits with options for guaranteed minimum withdrawal benefits (if the legal, counterparty and fee concerns can be overcome), conversion to lump-sum payout upon retirement, spousal benefit and pre-retirement death benefit; an annuity exchange to ensure competitive pricing; the potential to use laddered bond portfolios, target payout funds and/or Future Starting Bonds among other products available in the market place in the design of the Program’s target date fund; asset consolidation tools to bring non-Program assets into the Program; and the option for financial assistance in planning for retirement.”

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