DOL/Treasury's hearing on lifetime retirement income

Russell Investments' Testimony – Bob Collie Presenting

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On behalf of Russell Investments, thank you for the opportunity to testify here today on these important matters.

These hearings are based on the premise – a sound one – that the defined contribution system should be built around the provision of income throughout retirement, rather than simply the accumulation of assets.

Current disclosures are, however, a barrier to this objective. They facilitate inattentive and too often unsuccessful behavior from plan participants because they fail to make clear how the progress of the investment portfolio and the choices that the participant makes are connected to the standard of living that they can expect in their retirement.

I shall explain today how the disclosure of account balances can be improved. I shall explain why I believe that it is essential that the required calculations are standardized. I shall argue that disclosure should be neutral on questions of different investment strategies or products, and, finally, I will describe the wider context of the retirement income system within which these disclosures sit.

How then can disclosure be improved? The single most important step is deceptively simple. It is to supplement the reporting of the account balance with a second number: the account balance divided by an annuity factor.

In other words, show how much income the accrued account balance would buy in the market at today's interest rates for an older version of you who has reached retirement.

This is a simple, robust and meaningful number.

Of course, the accrued account balance is only one part of the total expected future retirement income. So it is desirable to show also the effect that the possibility of future investment returns above the rate of inflation would have and, adding yet another layer, the effect of future contributions.

But note that there is much less certainty attached to those sources of retirement income and they are not generally included in current reporting, which states only the accrued account balance. They are therefore supplementary numbers and it is best to build up the total projected income figure by separately showing the contribution of each source.

These supplemental numbers are helpful, but the focus on the basic account value equivalent is essential – that is to say, the current annuity equivalent of the accrued account balance.

There are several reasons that this is so valuable to disclose.

First of all, it is a very simple calculation. Assumptions are needed only for interest rates and mortality. The Society of Actuaries are more than capable of providing mortality tables that can be used for this specific purpose and prevailing interest rates can be observed in the markets at any point in time.

Secondly, it is the number that is the closest equivalent in terms of income to the account balance on which plans currently report and indeed to the social security statements with which most working age individuals in this country are familiar.

Thirdly, though simple it is a meaningful disclosure: by nature of how it is calculated, it is automatically expressed in terms of today's dollars; it assumes survival until retirement, and general levels of mortality thereafter. These are appropriate assumptions.

What is more, it is objective. It is objective because the lifetime income equivalent to a given sum of money is something that can be derived relatively easily from the market for annuities. The Agencies can produce a standardized version of the annuity pricing basis, designed to broadly mimic the market's pricing of this product.

This might be packaged, as suggested in the announcement of these hearings, as a standard program produced by the Agencies, or indeed it may even be possible to simply issue each month standard tables of the appropriate annuity factors.

Now, I do not mean to imply here that annuitization is necessarily appropriate in all, or even most, cases. However, the fact that this option exists provides us with a market-driven objective measure of what the lifetime income equivalent to a given sum of money is – in other words, the market's best estimate of the exact number which we are seeking to report.

Disclosure of account balances as lifetime income streams should be standardized. That's because if the results are to be meaningful then the lifetime income that is reported should depend only on the individual's circumstances, and not on who prepares the statement.

Without standardization, the reported level of expected income will vary according to who calculates it. The extent of this variation might be rather large. A colleague at Russell, Dr. Bill Madden, recently compared the results and recommendations – for a hypothetical plan participant whom he called Sharon – of five tools designed to measure plan participant progress toward retirement. The conclusions reached by the various tools were sharply divergent, even though based on the same data. For example, one indicated that Sharon needed to save only a little more to be on track to meet her retirement goals, another found that she would need to save an additional 44% of her salary each year to do so.

These extreme variations in results highlight the dangers of a non-standardized approach.

These comments on the need for standardization apply not only to the annuity equivalent value of the accrued account balance but also, indeed more so, to the projected impact of potential future investment returns and future contributions. These supplemental figures would require additional assumptions, assumptions that introduce considerably more subjectivity, and the pitfalls of a non-standardized approach become correspondingly greater.

All of these comments are predicated on the view that reporting should be neutral on questions of particular products or particular investment strategies. These questions do not belong in this discussion. The goal of including lifetime income disclosure is not to promote a particular approach to saving, be it a particular target date fund design or stable value product or active or passive management approaches or annuities or anything else.

So while good reporting is a necessary basis for planning – and none of what I propose would prevent additional planning tools from being developed by whoever wants to do so – that is a separate issue from the question of disclosure of account balances as monthly income streams.

Likewise, the quantification of uncertainty – a question raised in the announcement of these hearings – is a separate issue. It is difficult – some of us would argue impossible – to quantify uncertainty and even the best mathematical models have proved inadequate to this task at times such as the recent financial crisis. A full planning tool which looks at the risks and benefits that are offered by different investment strategies would certainly want to look at uncertainty – however, the simple robust approach to disclosure that we advocate would not presume to enter into such subjective territory.

I should address the concern, which some may have, that the lifetime income values reported under the approach I have suggested will be too volatile. However, accrued account balances are also very volatile and nobody – as far as I am aware – argues that disclosure of account balances at snapshots in time is inappropriate. That's because even though they are volatile, they are an objective best estimate of the current situation – and the same applies to the approach to income disclosure that I suggest. The reality is that a best estimate of what a given account balance will be able to purchase as a lifetime income will vary considerably over time, just as the account balance itself does. Clear reporting will inevitably reflect that volatility. It would do more harm than good to withhold the best available information because we do not like what it shows.

The simple changes that I have suggested would represent an important step in the realignment of the defined contribution system toward a retirement income focus.

To wrap up my remarks, I would like to put the question of disclosure into the context of the wider system, by drawing on analysis set out in a recent book, *The Retirement Plan Solution*, which I co-authored with Don Ezra and Matt Smith.

In this book, we describe three types of defined contribution retirement systems, which reflect three different attitudes toward what the plan is aiming to achieve. The first is the Bank Savings Model, which is how the very early 401(k) plans were built; these were designed to provide a tax-efficient savings vehicle and invested mainly with the goal of capital security. The second model is the Fund Supermarket Model, in which investment choice and growth of assets become the primary goals and this is where we stand today. But it is only the third of our three models, which we call the Retirement Income Model, which explicitly considers the objective of a postretirement income stream to last a lifetime.

There is no good reason that today's system should adopt the fund supermarket model rather than the retirement income model – it does so largely because the defined contribution system in the U.S. has been shaped by happenstance, as much as by design.

Will disclosure alone turn an imperfect system into a perfect system or move us instantly from a fund supermarket approach to a retirement income approach? Clearly not. But it is an essential component. It is a necessary step toward such goals as better savings rates and better take-up where appropriate of investment choices such as annuities or other retirement income products.

Disclosure of progress in terms of retirement income would be a force toward a better system, because, as has frequently been said, what gets measured gets managed.

I respectfully submit these comments for your consideration and would be happy to answer any further questions that you may have.

Thank you.

For more information:

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