Why income can't wait

The need is urgent—and the solutions are ready

BY BETSY MASSAR AND TONY MASTROGIORGIO

Retiring baby boomers are faced with a question they never imagined forty plus years ago: can they make their retirement savings last a lifetime?

When they entered the workforce, defined benefit plans promising lifetime income were the mainstay of retirement. Social security was a reliable safety net. Today, most defined benefit plans are closed to new participants and two-thirds[1] of workers do not expect social security to be a major source of retirement income.

The result? "Baby boomers on the verge of retirement face the very real possibility of outliving their savings," says Chip Castille, head of BlackRock's US and Canada defined contribution group. With 2.6 million baby boomers set to retire each year,[2] and an increased reliance on DC plans to fund retirement spending, the discussion among plan sponsors, policy makers and academics has increasingly turned to finding sources of lifetime income.

"The time has come to provide a better income answer," says Castille. "I think the DC industry is ready to respond."

UNDERSTANDING THE PROBLEM

78% of retirement assets are held in defined contribution plans and individual retirement accounts[3] designed to accumulate a lump sum savings. Balances built by diligent savers may appear large, but can those balances really sustain decades of retirement spending? Many participants simply cannot calculate how much they will need to live comfortably for the rest of their lives, nor do they know how to effectively spend their nest egg down over decades of retirement without running out of money.

Plan sponsors recognize the problem and are increasingly concerned about the future welfare of participants. Consider these findings from Deloitte's 2010 annual 401(k) benchmarking report:[4]

- Only 15% of plan sponsors surveyed believe that the majority of participants are saving adequately for retirement.
- 62% felt that their responsibility might include helping "participants to plan for a reasonable [income] replacement ratio."
- An additional 15% of respondents feel they have the responsibility to take a "very involved approach" to prepare employees for retirement.

And it is not simply a question of providing for those approaching retirement. Within many plans a gap has widened between older "haves" and younger "have nots." The "haves" maintain a level of participation

CHIP CASTILLE is managing director of BlackRock's US and Canada DC group.

INCOME ALERT

According to a 2009 McKinsey report on defined contribution, pre-retirees now have a 50% chance of outliving their life expectancy and "consistently underestimate their requirements for retirement income, overestimate their investment gains and grossly underestimate their expenses in retirement."

1 http://www.gallup.com/poll/1693/social-security.aspx#1

2 http://www.cbo.gov/ftpdocs/32xx/doc3213/EntireReport.pdf Figure 8, page 43.

3 Mark Iwry testimony, ref, Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, Statistical release Z.1 (June 10, 2010).

4 Deloitte 2010 annual 401(k) Benchmarking Survey, sec 1:1 (and Ex.7.7).

in a DB plan that will provide at least some income. The "have nots" will rely entirely on DC savings. There is an urgent need to provide income solutions now that will help today's younger participants approach their future retirement with the level of security enjoyed by previous generations.

READY FOR RETIREMENT INCOME

With this growing concern about longevity risk and retirement readiness, it's no surprise plan sponsors are kicking the tires of income solutions. In fact, the Profit Sharing/401(k) Council of America[5] reported that 91% of members surveyed were "aware of retirement income products."

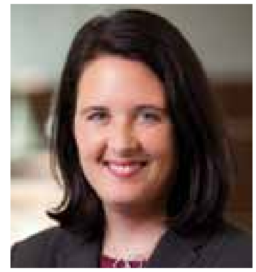
Last year's joint hearing of the US Labor and Treasury Departments on Lifetime Income Options for Participants and Beneficiaries in Retirement Plans drew hundreds of comments from industry leaders and academics, as well as participants and plan sponsors.

DC providers, plan sponsors and record keepers are responding to this growing demand. "We see a robust set of solutions in today's market, designed for a variety of participants and plan needs," observes Laraine McKinnon, a member of BlackRock's DC team. "Asset managers and record keepers have also come together to create technology standards that make it easier to add income solutions to record keeper platforms."

According to McKinnon, the recent spirit of collaboration and problem solving has been just what the DC marketplace needed to create momentum for retirement income products. "DC plan sponsors, as well as their consultants and advisors, really needed the industry to present a variety of products before they could begin to assess what income solutions would be best for their participants."

Much of the inventiveness, McKinnon adds, has come through new ways of using traditional income products. "Traditional individual annuities have not addressed DC participants' specific needs," explains McKinnon. "New solutions deliver many of the benefits of annuities, such as the security of guaranteed income, but have greater simplicity and ease of use. They also offer the liquidity of traditional DC investment solutions."

Thanks to the DC industry's creativity, factors such as flexibility, institutional



LARAINE McKINNON is a member of BlackRock's DC institutional sales and services team.

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"While plan sponsors appear to be concerned with the retirement readiness of their employees, they appear unsure about which tools and offerings are most effective at helping participants."

–Deloitte Benchmarking Survey

5 http://www.dol.gov/ebsa/pdf/PSCA091510.pdf

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Only 2% of 401(k) plan participants convert retirement savings into an annuity on retirement.

–Retirement Security Project, July 2009

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"I see the next generation of pension plan design as something we might call a 'structured-DC' plan, which is designed to produce the payout pattern and simplicity of a DB plan but to do so using a DC-type institutional structure."

–Robert C. Merton, Nobel Laureate

pricing, and transparency are now part of the conversation.

One income solution, typically called a guaranteed minimum withdrawal benefit (GMWB), puts an "annuity wrapper" around a portfolio of securities. A drawdown percentage is calculated based on the portfolio's high water mark to provide annual income. If the participant spends down their portfolio during retirement (while withdrawing no more than the set annual percentage), the annuity kicks in to provide income for the remainder of the participant's lifetime.

GMWBs offer several benefits, most notably that they create a safety net while maintaining the portfolio's market exposure. They have drawbacks as well, according to Chip Castille, who in addition to heading BlackRock's DC group was also the head designer of BlackRock's income solution. "GMWBs can be expensive and inflexible. If you withdraw cash, the payout may be recalculated at a lower level."

Castille believes that a second type of income solution that leverages collectively managed annuity pools offers more interesting possibilities than individual annuities—and more fully demonstrates how the industry has evolved to meet the need for retirement income delivered through a 401(k) plan.

"Deferred, unallocated annuities can be purchased on behalf of a large population," explains Castille. "They lock in future income at lower-cost institutional prices and we can manage and track them more efficiently than a collection of individual annuities. The challenge becomes how to best provide DC participants access to the annuity pool."

BlackRock's solution embeds the unallocated annuity pool into a target date fund structure, replacing the traditional fixed-income class. "It's a very elegant solution," says McKinnon. "As the participant nears retirement, they automatically accrue a greater share of future income."

RETIREMENT READINESS

For McKinnon, the story of 2011 is not about any one solution—it's about the industry's collective response to meeting the income needs of participants. "The DC industry has stepped up," McKinnon notes. "Plan sponsors now have a variety of income solutions and the operational framework to adopt them." DC

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