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Private sector a breeding ground for retirement security solutions

By Bernard Winograd

The impact of the financial crisis on workplace retirement plan balances has led to a reassessment of defined contribution plans and a sense of nostalgia for the guaranteed retirement paycheck that traditional defined benefit pensions provide. As the Obama administration looks at ways to provide Americans with greater retirement security, it should encourage the adoption of innovative private-sector solutions that can strengthen defined contribution plans while preserving the unique benefits these plans provide.

Today's defined contribution pension plans came into existence almost 30 years ago when the federal government revised pension regulations to allow employees and employers to contribute regular wages to tax-deferred retirement savings plans. The original intent of the legislation was not to replace traditional pensions or defined benefit plans. However, as more companies have frozen or terminated their traditional pension plans, defined contribution plans have become the primary retirement savings vehicle for millions of Americans.

During the long bull market in the 1980s and 1990s, 401(k) and other defined contribution plan participants, many with a limited understanding of the financial markets, saw their retirement account balances steadily rise, and came to expect that this would continue. The recovery of the markets after the bursting of the technology bubble reinforced the notion that individually managed retirement accounts offered the best path to financial security in retirement.

Today, things are different. The steep drop in stock prices has dashed the retirement plans of Americans from coast to coast. That this has happened just as the first wave of baby boomers approaches retirement has magnified the problem. Dreams have been scaled back, the idea of early retirement shelved and confidence in a comfortable retirement shaken.

Ideas have been proposed to protect individuals' retirement assets in the future, ranging from overhauling the existing system to completely replacing 401(k)s and other defined contribution plans with a government-mandated retirement savings plan. In the midst of the worst economic downturn in decades, it is not surprising that one of the objectives of these proposals is to replicate the guaranteed income once offered by traditional pensions. Americans need solutions that offer the best of both traditional pension and defined contribution plans. These solutions are available now.

Income guarantee

The insurance industry introduced a new generation of retirement products, with income guarantees tied to an individual's retirement assets, in the late 1990s. These annuity-based products provide individuals the opportunity to participate in rising equity markets, protect retirement income from market declines, and generate a guaranteed paycheck for life in retirement. These products are widely available to individual investors today and are becoming increasingly available to participants in defined contribution plans. While there are incremental fees associated with these guarantees, which make guaranteed products more expensive than traditional 401(k) options, the value of the protection they provide has never been more apparent than during the recent market downturn.

Insurers are able to offer income guarantees because of their ability to pool longevity risk across large and diverse populations, and to implement hedging strategies to protect retirement income during adverse markets. These solutions would be expensive — and difficult, if not impossible — for individuals to replicate on their own through personal investment strategies. Of course, individuals adopting such solutions are relying on an insurer to fulfill its obligations for decades to come — a potential risk. Therefore, the financial strength of the company offering the product is an important consideration. Given the events of the past year, a number of stakeholders, including regulators and employers, are appropriately scrutinizing providers of income guarantees to ensure that these providers possess the required financial strength and risk management discipline. There are ways to structure the products to address these concerns, but the complexities of the structuring mean that plan sponsors will need to dive deep into details to get comfortable.

Cheers for 2006's PPA

Congress should be commended for passing the Pension Protection Act of 2006, which represented an important move forward in improving Americans' ability to save for retirement. The act enables employers to automatically enroll their employees in 401(k) and other defined contribution plans, and to automatically direct employees' contributions to certain default investments, called qualified default investment alternatives. Products with income guarantees were among the investment options approved as QDIAs. Congress can further encourage the creation of guaranteed retirement income from defined contribution plan accumulations by making guaranteed income the default distribution option in defined contribution plans — whether from traditional income annuities or newer guaranteed-income products.

A vigorous discussion of a broad range of solutions that can contribute to meeting the financial needs of the country's aging population is essential. Importantly, a key part of the solution — products that enable individuals to participate in market increases, protect retirement income from market declines and generate a guaranteed paycheck for life in retirement — is already available. While the debate continues, the adoption of these products within defined contribution retirement plans should be encouraged.

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