DC In-Plan Retirement Income Solutions — Are We There Yet?

Part 1 of an in-depth analysis of retirement income solutions.

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Executive Summary

In the fall of 2016 the Plan Sponsor Council of America (PSCA) conducted a snapshot survey to gage whether plan sponsors are adding guaranteed income products to their plans. At the time of the survey, only five percent of all plans offered a retirement income guarantee product in the plan. The survey indicated that large plans were more likely to offer an income guarantee product (5.7 percent) versus small plans (4.4 percent). The types of retirement income guarantee products offered included Guaranteed Minimum Withdrawal Benefits (GMWB)/Guaranteed Lifetime Withdrawal Benefits (GLWB) (40 percent), Traditional Fixed Annuities (33 percent), Variable Annuities (33 percent), Managed Account Services (26.6 percent), Managed Payout Funds (13.3 percent), and Deferred/Longevity Annuities (13.3 percent).

There have been several developments in the industry, both from regulators overseeing the products and asset managers creating the products relating to in-plan retirement income products/solutions. At the same time, there has seemingly been more interest by plan sponsors and participants, in terms of those expressing a desire for some sort of "guaranteed income" in retirement. According a MetLife Lifetime Income Poll that was conducted in 2016, a large majority of plan sponsors surveyed (85 percent) agreed that the core purpose of

a DC plan should be to serve as a source of income during retirement.

The decision to offer an in-plan retirement income solution is a fiduciary decision that rises to the top of potential concerns cited by the PSCA survey. When plan sponsors were asked to identify the top nine concerns about adding a retirement income guarantee product to the plan, they expressed fiduciary exposure the highest at (38.3 percent) for all plans, however that number jumps to 56.9 percent for plans with more than 5,000 participants. Other concerns were high costs (33.3 percent), operational hurdles such as recordkeeping issues (32.9 percent), non-portability (28.9 percent), risk exposure from the insurer guaranteeing the product (26.5 percent), lack of interest from participants (17.3 percent), and "not the role of the employer" to provide lifetime income products (13.3 percent).

Still, the market and appetite for these options continues to evolve. As we continue to monitor the options available to plan sponsors, PSCA wanted to resurface the options available to plan sponsors and provide an update on developments within the industry.

Background

As defined benefit plans become rarer in today's workplace, and questions linger around the viability of social security, many American workers face the burden of supporting themselves via their personal savings during retirement. To help with this task, many employers offer defined contribution plans, allowing employees to save for retirement using these tax-advantaged vehicles.

While there has been an evolution in the investment options offered to help participants navigate a menu of products during their working years, or accumulation phase, including target date funds and managed accounts, there has been less progress made on helping participants manage their spending or consumption needs during their retirement years, or the decumulation phase of their life. Evolving attitudes toward keeping participants' assets in the workplace retirement plan, as well as effects of the Department of Labor's Fiduciary Rule on industry players that may have previously tried to roll more assets outside of the plan, may create a more pressing need for options to include within the plan.

In the following pages, we will discuss the challenges participants face as they prepare for retirement, especially in light of the void left by the diminished role of defined benefit plans. We will then provide an overview of the current retirement income product market, discussing the benefits and potential drawbacks of various solutions. After laying out the benefits, to both participants and plan sponsors, of an in-plan solution, we discuss a few potential barriers plan sponsors may face in implementing such solutions.

Risks Facing Participants in Retirement

In the defined contribution paradigm, employees face a new set of investment risks as they plan for their retirements — risks that were previously borne by the sponsors of defined benefit plans. These risks include:

- **Longevity risk:** the risk of outliving retirement savings. As life expectancies continue to rise and health care costs continue to soar, the risk that retirees will exhaust their retirement savings before they die has increased.
- **BTNB risk:** The BTNB (buy the new boat) risk is when an individual takes a lump sum from their retirement account and decides to make the big purchase they have always dreamed of and subsequently spends too much in retirement where their assets are spent down too early and are extinguished prematurely.
- **Shortfall risk:** there are a few things that can contribute to shortfall risk. First and foremost is the lack of adequate savings during one's working years. The second potential shortfall risk is called sequence of returns risk, the risk of suffering an investment loss with an inadequate time horizon with which to recoup that loss. The frightening and disheartening experience of older employees and retirees losing a significant chunk of their retirement savings in 2008 cannot be minimized.
- **Inflation risk:** the risk of the erosion of the purchasing power of retirement savings. In periods of high inflation, more of the retiree's income is required to purchase the same goods, causing retirement savings to dwindle more quickly.
- **Expenses:** the cost of purchasing or investing in a retirement income product can eat away at retirement savings.
- **Cognitive risk:** the risk that retirees may make poor investment decisions as they age, or may become more prone to be victimized by fraud.

What Participants Are Looking for in a Retirement Income Solution

In light of these risks, following are several attributes that are key to employees as they evaluate the various retirement income solutions available to them:

- An income stream that is guaranteed to last a lifetime.
- Low costs/expenses.
- Protection of the market value of retirement savings from declines in the years immediately prior to retirement and in retirement.
- Potential for participation in market value increases during retirement — this may be very important in terms of inflation-protection.
- Participant's ability to access savings, in case of emergency.
- Inheritance potential.

Several surveys of 401(k) plan participants reveal that generating stable income is the most important attribute of a retirement income solution to most participants. For example, a survey by MetLife *(MetLife Retirement Income Practices Study, June 2012)* showed that 68 percent of the participants would prefer a guarantee of stable income, albeit with lower returns, to the potential for higher returns without a guarantee. Additionally, according to an SSgA survey *(SSgA DC Investor Survey, July 2013)*, 74 percent of plan sponsors and 55 percent of participants prioritize security of lifetime income over liquidity and level of income, and 80 percent expressed that a guaranteed monthly payout is a "must have."

According to these same surveys, the protection of the market value of savings is the secondary priority, and third is allowing participants ready access to their savings.

Retirement Income Solutions and Products

Investment management firms and insurance companies are quickly responding to the new set of investment risks and income needs for defined contribution participants by introducing a wide array of retirement income products. Most retirement income solutions can be grouped into three categories: investment-based, annuity-based, and blend of investment and annuity-based products. A description of the most common solutions follows, as well as a brief discussion of the benefits and drawbacks of each type of solution.

Investment-based Solutions

Managed Payout and Retirement Income Funds are designed to provide a steady stream of retirement income while allowing investors control and access to their accounts. Offered by investment management companies, these funds make regular distributions out of the participant's account balance, in an amount (or percentage) designated by the participant. When the participant's account is depleted, and the account balance is zero, the distributions stop. There is no guarantee that the participant balance will provide income for life. As such, they do not address longevity risk, nor do they resolve shortfall or inflation risk. Investors are subject to the effects of market declines, but do participate in market rallies. If there is a balance left in the account upon the investor's death, it is distributed to beneficiaries.

These solutions may be appropriate for participants that wish to minimize fees and maximize their ability to change course during retirement and respond to unexpected situations as they arise.

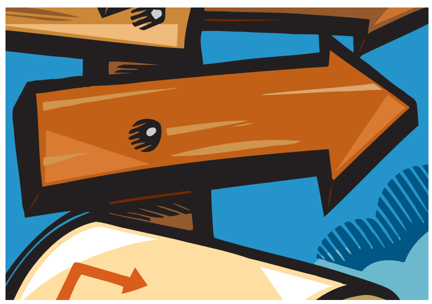
Managed (Retirement Income) Accounts are more of a service than a product. Participants hire an advisor to manage their accounts, with objectives of capital appreciation, income, and inflation protection. The participant, with counsel from the advisor, determines the amount and timing of distributions. Similar to managed payout and retirement income funds, these accounts are not insurance-based, and thus, cannot offer any type of guaranteed income stream. Investors have some control over the accounts, have access to their assets and participate directly in market value appreciation. However, managed retirement income accounts do not guarantee lifetime income and they are subject to market volatility, and therefore they do not address longevity or shortfall risk.

These solutions may be appropriate for participants that have significant retirement assets outside of their employer-sponsored plan and/or may have assets well in excess of those needed to support a desired spending level in retirement. This approach also maximizes optionality and preserves their ability to change course during retirement and respond to unexpected situations as they arise.

Annuity-based Solutions

Annuity-based solutions offer income guarantees and, as such, may only be offered by insurance companies. There are a wide variety of annuities available to investors, which can be offered with a wide variety of features (such as inflation-adjustments and joint survivor benefits). Following are the most common annuity-based retirement income solutions:

Traditional Fixed Annuities (or Immediate Annuities) are the most common and recognized retirement income solution. The investor purchases annuity units from an insurance company (makes a deposit) in exchange for the insurance company's guarantee for a specified guaranteed income stream for life (or any specified period of time). The insurance company manages the participant deposits in its General Account, pooling the deposits of all its participants. The insurance company profits by earning more in its General Account than it needs to pay out in benefits. The participant relinquishes all control over those deposits and the insurance company takes on the risk of market value declines and enjoys the benefits of market value appreciation. The participant does not participate in those market value gains or losses.



The key benefit of a traditional annuity contract is the lifetime guarantee of the income stream in retirement (and the possibility of extending that guarantee for the lifetime of the participant's spouse), which addresses longevity risk: the annuity purchaser cannot outlive his or her income. In turn, cognitive risks are also eliminated. However, participants relinquish control over their investments once the annuity is purchased. They cannot withdraw funds in the case of an emergency and they do not benefit from market rallies. Additionally, there is no possibility of a residual market value being left to heirs.

Traditional fixed annuities are an ideal solution for people that wish to maximize regular consumption, but offer little flexibility, if any, respond to unexpected financial situations as they arise. They are, effectively, the most cost-effective way to spend every last dime of retirement savings, and may be suitable for people who have no desire to leave a bequest.

Variable Annuities are similar in some respects to fixed annuities, though, as the name implies, the amount of income provided varies. Investor deposits are not invested in a General Account, but are invested in underlying sub-accounts, available in a variety of asset classes. Income payouts vary as they depend on the performance of the underlying sub-account(s). Variable annuities do not protect the participant against downside risk of investment losses and loss of income after retirement, but they do allow participants to benefit from market appreciation. They also allow for some participant control over the assets, as investors can choose the asset classes in which their deposits are invested. Variable annuities can provide a lifetime guarantee, which could solve for longevity risk.

Longevity Annuities (also known as deferred annuity contracts or longevity insurance) are a type of annuity in which units of insurance are purchased that provide a specific amount of income, guaranteed for life, with payouts beginning once the contract holder reaches a specified age (typically 85). Contributions to the longevity insurance account are typically invested in the insurance company's General Account and are not accessible to the account holder.

The benefit of longevity annuities is that they act as an effective safety net if the income stream from other retirement investments becomes exhausted. Longevity annuities protect investors against the risk of cognitive decline. The primary drawback is that the retiree pays for it, but may die before using it. Additionally, the participant relinquishes control over the assets, cannot make emergency withdrawals and is not able to use unused assets for inheritance purposes.

Blended Solutions

Guaranteed Lifetime Withdrawal Benefits (GLWBs), sometimes called Guaranteed Minimum Withdrawal Benefits (GMWBs), are retirement income products that combine features of investment products and annuities.

GLWBs are insurance riders that typically combine a commingled or mutual fund (such as a balanced fund or target date fund) with a guaranteed income stream feature ("wrapper") that is similar to an annuity. Because of the guaranteed income feature, GLWBs are issued only by insurance companies. In contrast to a traditional annuity, in a GLWB participants pay an explicit fee in exchange for the insurance company's promise to pay a guaranteed lifetime income stream.

As the market is continually evolving, there are variations in the specific features of these products. In general, however, there are two stages associated with GLWBs: accumulation and decumulation. During the accumulation phase, participants make contributions into the GLWB, usually in the years preceding retirement. These assets are invested in some kind of balanced investment fund designated by the GLWB provider. The participant's account value, on a specified annual date, is called the "benefit base" or "income base." The initial determination of the benefit base is typically ten years prior to retirement. Any increase in the account value on the anniversary date resets the benefit base to the new, higher amount. The benefit base cannot be lowered due to poor investment performance or due to the effect of fees and expenses. The amount of income that the GLWB will pay out during retirement (the decumulation stage) is equal to a certain percentage of the benefit base. If the account balance is depleted before the participant dies (assuming expected withdrawal behavior), the insurance company must continue to pay payments. If the participant dies leaving an account balance, that balance gets passed on to named beneficiaries.

With GLWBs, insurance companies are striving to provide a product that offers more of the features desired by participants. GLWBs, for example, provide a guaranteed lifetime income stream and, as such, give downside protection, as would an annuity; however, unlike an annuity, they also provide the participant with more flexibility and control over the account balance. Participants can take emergency withdrawals and they have the opportunity to participate in market rallies.

However, all these features come at a price. Not only do participants pay the expense ratio of the underlying investment fund, but the products that are currently available in the marketplace also charge a fee (typically between 1 percent and 1.5 percent) for the insurance guarantee component. The total expenses of GMWBs, which are borne by the participant, are typically between 1.75 percent and 2.50 percent. Moreover, these expenses get charged during the accumulation phase, which typically begins ten years prior to retirement, as well as in the decumulation phase. As expenses reduce the account value, the negative effects of the expenses are compounded annually and are reflected in a reduced account balance, thus limiting the potential increase in the benefit base. Because the amount of retirement income is calculated as a percentage of the benefit base (the participant's account balance on a specified anniversary date), the compounded effect of high fees during the accumulation period, in particular, can have a significant impact on the amount of income the participant will receive in retirement. It is also important to note that while the idea of participating in market rallies is attractive, the reality is that once income payouts begin, the chances of a net increase in the participant's account (the market appreciation less the distributions made from the account) on the anniversary date becomes increasingly difficult as time goes on.

The table shown at https://www.psca.org/Investments_winterDCI_2017 depicts the features and benefits, in terms of participant preferences, for each of the retirement income products discussed. Looking at the table, it appears that GLWBs offer participants most of the attributes they feel are most important to them.

In addition to specific products, plan sponsors can make decisions to set up the retirement plan to have features that make keeping assets in the plan more optimal. For example, allowing for systematic withdrawals would enable participants to withdraw a set dollar amount or percentage of assets from their balances over time, enabling them to design their own income stream. Not all record-keepers offer this service, so plan sponsors may need to work with their provider to confirm what options are available.

More so, record-keepers are making strides to help participants understand the level of income they can expect to receive from their retirement assets. Such features as adding a "monthly income" projection feature to the plan website can help participants see what their current balance may purchase in an annuity, helping to right-size expectations for whether participants are saving enough to provide a comfortable level of income in retirement.

In part II of this article, to be published in the Spring 2018 edition of *Insights*, we will provide an overview of considerations and fiduciary obligations regarding offering a guaranteed retirement income solution in the plan.

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