Defined contribution (DC) plans such as 401(k), 403(b) and 457 plans are now the most prevalent type of plan for delivering retirement benefits in the private sector of U.S. employers, and their prevalence is increasing in the public and union sectors of the workforce. With these plans, participants bear the responsibility for deciding how much to save and how to invest their contributions while they are working.

In recent years, DC plan sponsors have implemented features in their plans that have made significant progress in addressing these challenges. Newer features include autoenrollment, autoescalation of contributions, design of the investment lineup of funds under the Employee Retirement Income Security Act (ERISA) Section 404(c) and qualified default investment alternatives (QDIAs), including target-date funds.

The Remaining Problem

With DC plans, however, participants face another important challenge as they approach and enter retirement: turning their savings into reliable retirement income. Currently, the most common practice is for plan sponsors to distribute a lump-sum payment to participants upon termination of their employment or retirement. Participants are then on their own to generate retirement income from their savings throughout their retirement years or to engage a retail financial institution or financial advisor to help them with this task.

This practice creates a challenge for many workers who...
Employees who have saved for retirement may need help from employers to take the next important step—figuring out how they’ll generate reliable retirement income from those savings.

...and don’t have sufficient financial literacy to generate adequate retirement income strategies—a complex retirement planning task even for those who are better informed. In addition, research on behavioral finance demonstrates that many people do not have the discipline necessary to develop a retirement plan and self-execute it. One other issue is that lower and middle-income plan participants who seek financial advice to generate retirement income may not have access to competent and unbiased financial advisors and institutions or even know how to seek such help.

What percentage of plan participants might need help with this task? We can get an estimate by looking at a few recent surveys on general financial literacy:

- According to the 2013 Consumer Finance Literacy Survey, 40% of respondents give themselves a grade of C, D or F on personal finance knowledge.
- In the Consumer Survey conducted by the Secure Retirement Institute of the Life Insurance and Market Research Association, 48% of respondents rank themselves as "not at all knowledgeable" or "not very knowledgeable" about investments and financial products.

And keep in mind that generating income in retirement from savings is one of the most complex financial decisions consumers ever make and that the investment and financial products are often quite complex.

The 2014 Retirement Confidence Survey from the Employee Benefit Research Institute provides insights on workers’ views on generating retirement income from savings:
85% of survey respondents would find an estimate of retirement income from savings “very useful” or “somewhat useful.”

88% would find recommendations on sustainable withdrawal amounts for lifetime income “very valuable” or “somewhat valuable.”

This is just a hint of the evidence showing that retiring employees are very concerned about generating retirement income from savings. Clearly, large numbers of people want and need help with this critical retirement planning task, which points to the need for the next evolution in DC plan design.

How Plan Sponsors Can Help

Plan sponsors can help retiring participants by implementing programs of retirement income in their plans. For the purpose of this paper, a program of retirement income in a DC plan refers to the following:

- One or more mechanisms that convert a participant’s account balance into periodic retirement income
- Disclosures and communications to plan participants to help them make an informed choice of a retirement income option
- Administrative assistance with implementing participants’ elections, including rules that participants must comply with to carry out their elections.

Employers and plan sponsors are in a unique position to help retiring employees generate retirement income from their DC accounts. Here’s why:

- Employers and/or plan administrators often have the resources to conduct the due diligence to select, implement and communicate retirement income programs, tasks that are difficult for untrained individuals.
- Employers and/or plan administrators can significantly increase the odds that retirement solutions will be adopted if they make it easy for retiring employees to elect and implement a solution.
- Employers and plan sponsors can be the unbiased institutions that act solely on behalf of their plan participants, without regard to financial compensation that might depend on participants’ elections. It’s the responsibility of plan fiduciaries to act in the best interests of plan participants.
- Institutional pricing and competitive annuity bidding platforms available to employers and plan sponsors can significantly increase retirement incomes compared with retail solutions. A recent study by the Stanford Center on Longevity estimates that the amount of retirement income can be increased by 10% to 20% by using institutional pricing compared with retail pricing.

In summary, plan sponsors can deploy their bargaining power, scale, ability to standardize and distribution efficiency to improve the retirement security of plan participants.

An Overview of Retirement Income Generators

When deciding which type of retirement income generators (RIGs) to select, a plan participant should consider the amount of periodic retirement income they’ll be able to generate, the length of time the income is expected to be paid, access to savings, guarantees of lifetime income and the circumstances under which the amount of income could change. Here are three general methods for generating retirement income from savings that have distinct characteristics regarding these goals:

1. Systematic withdrawals: With this method, retirees invest their assets and draw down the principal and investment earnings with a formal method to deliver periodic payments that are intended—though not guaranteed—to make the money last for life.

Learn more >>

Education
Certificate Series
February 23-28, Lake Buena Vista (Orlando), Florida
Visit www.ifebp.org/certificateseries for more information.

From the Bookstore
Money for Life: Turn Your IRA and 401(k) Into a Lifetime Retirement Paycheck

Recession-Proof Your Retirement Years
2. **Annuities**: With this option, retirees transfer their savings to an insurance company that guarantees a lifetime retirement income. Note that some insurance company products provide this guarantee but don’t use the name *annuity* in their disclosures and marketing materials.

3. **Period-certain payouts**: In this instance, retirees invest their assets and take periodic payments over a fixed period, after which the assets devoted to this solution are exhausted.

Within the first two categories of RIGs, there are many variations:

- **Systematic withdrawals**: self-managed through in-plan installment payment feature, professionally managed account or managed payout fund. Common withdrawal strategies include constant dollar amount (with or without adjustment for inflation), endowment method (constant percentage of assets) and life expectancy method (withdrawals spread over remaining life expectancy). Another variation is to pay out only interest and dividends without withdrawing principal.

- **Annuities**: immediate fixed income annuity (otherwise known as single premium immediate annuity or SPIA), immediate variable income annuity, immediate inflation-adjusted income annuity, deferred fixed income annuity, deferred variable income annuity, *longevity insurance* (deferred annuity starting at an advanced age) and guaranteed lifetime withdrawal benefit (GLWB; may also be called a guaranteed minimum withdrawal benefit, or GMWB). Annuities could be offered through insurance contracts in the plan or through an out-of-plan solution, such as a rollover to an individual retirement account (IRA) that uses an annuity bidding platform and is operated under the IRA rollover rules.

With period-certain payouts, the most common variation is the length of the payment period.

Here are the distinct goals and circumstances that each of these types of RIGs meets, along with their associated risks:

- **Systematic withdrawals** are typically preferred if the most important goals are flexibility, access to savings, possibility for a legacy with unused funds and the potential for an increase in retirement income if investment performance is favorable. The risk is that savings can be depleted if retirees experience poor investment performance and/or live well beyond predicted life expectancies. Another risk is that participants may lack financial discipline and spend savings too rapidly.

- **Annuities** are typically preferred if the most important goals are the guarantee of lifetime retirement income and protection from investment losses. Annuities often provide higher initial retirement income than systematic withdrawals, due to the pooling of longevity risk. The risk is that with many annuities, retirees do not have access to savings, there’s no potential for a legacy with unused funds and retirement income isn’t increased by favorable investment performance. Fixed income annuities are subject to the risk of inflation unless they provide an inflation adjustment. Annuities are also subject to the solvency risk of the issuing insurance company, although protection from state guaranty associations can mitigate this risk.

- **Period-certain payouts** could be used to enable retirees to delay Social Security benefits in order to optimize the value of these benefits or to generate income until an age at which another source of retirement income begins, such as a deferred income or longevity annuity. The risk is if there is no arrangement for retirement income to continue after the certain period has elapsed or if the participant is not aware that the retirement income stops at that time.

### Designing a Program of Retirement Income

There’s no “one-size-fits-all” RIG. Retirees will experience different circumstances in the following areas:

- Tolerance for risk regarding expected investment returns and inflation, depending, in part, on other sources of retirement income as well as the amounts of their nondiscretionary and discretionary living expenses
- Degrees of optimism or pessimism about the economy
- Life expectancies based on their family history and lifestyle
- The self-discipline required to manage a systematic withdrawal approach
- Other sources of financial security in retirement, such as a pension, employment income or home equity
- Their life circumstances and expected pattern of retirement living expenses, such as dependent children
or parents, home mortgages, debt repayment and so on.

To accommodate these different circumstances, a plan sponsor might want to offer at least one RIG from each of the above three categories of RIGs. Upon retirement, participants could be free to devote all their savings to one RIG or make partial allocations among two or more RIGs. Two or more RIGs could also be packaged into retirement income solutions that meet specified goals.

Most DC administrators can easily implement at least one form of each of the three RIGs mentioned in this article. For example, installment payment features that can accommodate systematic withdrawals and period-certain payouts are available on the administrative platforms of most DC administrators. In addition, there are annuity bidding services that operate through an IRA rollover and can offer simple fixed or inflation-adjusted immediate annuities. In this case, the only administrative requirement to implement an annuity is the ability to facilitate an IRA rollover, which most DC administrators can accommodate.

Sophisticated plan sponsors could adopt RIGs with more extensive administrative requirements and/or higher administrative costs to meet the needs of their plan participants. These options include in-plan annuities, hybrid annuities such as GLWB products or solutions that combine systematic withdrawals and annuities.

Other possible refinements to the simple retirement income menu include:
- The ability to elect guaranteed retirement income options in the period leading up to retirement to enable plan participants to protect their retirement income as they approach retirement
- The option for participants to change their elections after retirement as their circumstances and goals change. One example would be if a participant wants the flexibility of systematic withdrawals to generate retirement income in the years immediately following retirement but, after several years in retirement, would like the lifetime guarantee of an annuity.
- Packaged solutions, such as systematic withdrawals until an advanced age, such as 80 or 85, and a qualified longevity annuity contract to pay a guaranteed lifetime income thereafter, as enabled by recent Treasury regulations.

An important feature of any retirement income program is the default payout option, which would kick in if a plan participant does not make a positive election. Behavioral finance research has shown that defaults can have a powerful influence on retirement decision making. At this point, however, without specific guidelines from regulatory agencies, many plan sponsors are hesitant to specify default retirement income solutions for fear of incurring fiduciary liability.

But there is already a “de facto” default in place that many plan sponsors could use: the required minimum distribution (RMD) rules that specify the minimum amounts that must be withdrawn from participants’ accounts starting at the age of 70½. A plan sponsor could combine the RMD with the QDIA that applies to retired participants. It could be argued that a retirement income solution based on the minimum amounts IRS requires to be withdrawn from accounts would minimize a plan sponsor’s fiduciary exposure, since IRS requires these amounts to be withdrawn anyway. Participants could make a positive election if they don’t want to be paid according to the RMD.

Plan Sponsor Challenges

A recent Aon Hewitt study listed...
the most common barriers cited by plan sponsors to implementing retirement income programs:

- 54% of plan sponsors surveyed cited administrative complexity. Plan sponsors could address this objection by using a simple retirement income program with installment payment features and an IRA annuity bidding platform, as described above.
- 51% cited fiduciary liability. Plan sponsors could address this concern by offering the three types of retirement income solutions described above, instead of trying to find the one best solution (which most likely doesn’t exist) to meet the needs of all participants. The RMD default strategy can also help address fiduciary concerns.
- 50% were waiting to see the market evolve. Many plan administrators and financial institutions are now offering a variety of retirement income solutions. While the market will certainly evolve in the future, currently there are many viable solutions, many of which are much better than offering no solutions at all.

The reality is there are no perfect retirement income solutions. Plan sponsor fiduciaries must make decisions despite uncertainties about future regulatory developments, the investment climate and financial innovations. The best way to proceed is for plan sponsors to develop the business case for implementing programs of retirement income. Once they’re convinced that such a program best meets the needs of their plan participants, they’ll have the resolve to overcome any barriers that they encounter.

Call to Action

Plan sponsors can serve their employees’ diverse needs by offering RIGs to retiring employees, accompanied by decision support and assistance with implementation. This will deliver important benefits to individuals and society in general:

- Employees can retire with confidence and security, which will help them more fully enjoy their retirement years.
- It will help prevent employees from living in poverty in retirement after exhausting their savings.
- By offering institutional pricing, plan sponsors can significantly increase the amount of retirement income that participants might receive.

DC plan sponsors have recently made significant improvements to their plans by implementing autoenrollment, autoescalation of contributions and professionally managed accounts such as target-date funds. The next evolution in plan design is help with generating reliable, lifetime retirement income.

Note: Portions of this article are excerpts from recent reports by the Stanford Center on Longevity:


These reports can be downloaded from the Center’s website, http://longevity3.stanford.edu/publications.

Endnotes

2. 2013 Hot Topics in Retirement, Aon Hewitt.