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Examining Income Replacement During Retirement in a Defined Contribution Plan System

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Description

As our retirement system continues to trend toward expanding defined contribution plans (DC plans) and shrinking defined benefit plans (DB plans), a growing number of employees will be forced to rely increasingly on their accumulated account balances in DC plans to provide financial security during their retirement years. As the number of employees in this situation continues to grow, these individuals will face important decisions regarding how to make their account balances last for a desired length of time, and in many cases, last throughout their retirement years, a period in life that is becoming increasingly longer due to improved longevity.

In the not-so-distant past, the challenge of providing retired employees with a source of income to last during their retirement was primarily met through employer-sponsored DB plans. However, with a continued shift from DB plans to DC plans as a primary source of retirement income, there is a growing need to examine alternate options designed to address participants' retirement income needs, and more importantly, to assist participants in understanding how to translate their account balances into a steady stream of income that is continuous throughout their retirement years.

In response to this need, some DC plans offer annuity distribution options, either through commercial annuities that are incorporated inside the DC plan, or via transfers to a DB plan also sponsored by the same employer.

Another option is to provide access to the account balance by the participant. When offered the opportunity to gain access to account balances, as is the case when employees near retirement, or when beneficiaries become entitled to the funds accumulated in the account, many individuals elect to take a series of withdrawals from the plan. Often, this option is exercised without any understanding or expectation of whether the amount will last throughout their retirement years. In some cases, other participants opt to receive a lump sum distribution, where the account balance is paid either directly to the individual, rolled over to another plan, or rolled over to an Individual

Retirement Account or an Individual Retirement Annuity (IRA). Often, little planning, if any, is done to ensure that the account balance is transferred to a source of income to be paid over the period of the participant's (or beneficiary's) retirement years.

In instances where the participants opt to leave their account balance in the plan without depletion, they can be faced with multiple options regarding how to improve their chances that the account balance will last for the elected period. These options can range from taking withdrawals (scheduled, unscheduled, or both) to annuitizing the account balance (partial or total; immediate or deferred; etc…), and additional alternatives that fall in the middle of the range. Generally, the availability of these options raises some important questions for fiduciaries and plan sponsors, including, but not limited to:

- Whether the plan should focus on providing a single option or multiple options in an effort to adequately address the different needs of participants, including diversification;
- What are the major factors to be considered by the plan sponsor in making these options available; and,
- Whether there are additional fiduciary considerations raised by making various options available, and the prudent management of these issues while adequately assisting plan participants.

Objective and Scope

The Council is examining the topic of income replacement in a predominantly DC plan retirement system. The examination will focus on:

A. What are the challenges participants face in making their account balances in DC plans last for the length of their retirement years, including improved longevity?

B. What are some of the alternative options available to participants that would be helpful in their efforts to make their accumulated savings last over their retirement lives or the lives of their spouses?

C. What are the considerations and challenges plan sponsors encounter when making some alternative options available to plan participants?

D. What are the considerations and challenges faced by plan sponsors in providing education outreach for participants regarding the available income replacement options?

Questions for Witnesses

1. What options could be made available to plan participants to best utilize their account balance(s), and to facilitate the goal of securing a stream of income over the elected period designated by the participant? Discussion of the options, generally, may include:
    a. Scheduled withdrawals from general investment options, or from more specific investment options, such as Target Date Funds, and including investment strategies employed by some of the funds in an effort to match expected/assumed distribution schedule to underlying investment allocations.
    b. Scheduled withdrawals combined with withdrawal or income guarantee features, such as guaranteed minimum withdrawal or income benefits (GMWB, GMIB) with respect to deferred annuity or accounts.
    c. The range of options regarding annuities designed to provide a stream of income for life, or over a fixed number of years. The options being considered could include those with features that allow for full or partial immediate annuitization, longevity annuities, or other products.

2. What factors should the participant consider with respect to income replacement options described above?
3. What are the risks plan sponsors face with respect to certain options, and how can these risks be minimized?
4. What are the factors to be considered by the plan sponsor regarding the options to be offered under the plan, such as participant demand, product portability risks, and fee structure?
5. In considering education alternatives with respect to income replacement, what role should an employer play with respect to retirement savings held outside of the employer-sponsored plan?
6. What fee disclosure requirements would apply for providers/plan sponsors to participants with respect to income replacement options?
7. What unique considerations, if any, would be required by the fiduciary for any of the options being offered?
8. Do the fiduciary concerns interplay with other potential barriers, and if so, what are those barriers?