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Examining Income Replacement During Retirement in a Defined Contribution Plan System

As the proportion of employees with a Defined Benefit (DB) pension continues to decline, guaranteed lifetime retirement income (outside of Social Security) in an employer sponsored retirement plan is a growing unmet need for the nation's workforce. Despite the proliferation of annuity product offerings from the insurance industry and the start of the Baby Boomer generation entering their retirement years, lifetime income annuity sales have not increased materially. Further, the estimated election rates of lifetime income options from deferred annuities remains stuck at well below 5%[1]. In the meantime, life expectancies continue to improve (it is now estimated that, for a 65 year old married couple, there is a 50% probability that at least one spouse will live to age 90, and a 25% probability that at least one spouse will live to age 95[2]). All of this is evidence of a coming retirement income crisis and begs the question of what role income options, particularly lifetime income options, should play in Defined Contribution (DC) plans. For the most part, the biggest challenges currently relate to:

- Lack of participant education;
- Lack of plan sponsor understanding; and
- Lack of inclusion of annuities in DC plan investment menus.

For participants, TIAA-CREF experience has shown that many participants do not understand how much income they will need in retirement, how much they need to save prior to retirement, and fail to properly convert their DC plan retirement savings into adequate income once they reach retirement. Our research[3] shows that keeping it simple and leveraging "inertia" can help improve these outcomes. Providing tools that help participants determine a retirement income target, using default options that include annuities in the accumulation phase of the retirement plan, and providing DB-like income projections throughout the accumulation years, results in participants being 2 ½ times more likely to use lifetime annuities as a significant part of their retirement income program[3]. In addition, with proper participant education, TIAA-CREF has seen more than 25% of new retirees take an annuity payment as their first draw. As participants age in retirement, annuity payments increasingly become part of their income.

In the case of plan sponsors, the DC market has become focused on managing fiduciary obligations. But fiduciary committees and their consultants may lack the understanding of how to select and monitor lifetime income options. The 401(k) market in particular, is focused more on wealth accumulation, where choosing a fund menu with options that currently have a Morningstar rating of 4 or 5 on an open architecture platform has become the norm because it is "defensible" from a fiduciary perspective due to the perception of quality. However, when it comes to annuity income options, the selection and ongoing monitoring of an annuity carrier and appropriate contract can be mystifying to plan sponsors and their consultants. Ensuring that retirees will receive income checks throughout the remainder of their lifetime requires the annuity provider to be around for decades, making a prudent carrier selection appear to be a daunting fiduciary responsibility.

Income Options

The inclusion of low cost annuities in the investment menu of a DC plan differentiates it from an investment plan designed mainly for wealth accumulation purposes. Our almost 100 years of experience at TIAA-CREF has shown that providing participants with the ability to elect lifetime income from a variety of income options produces better income replacement and retirement outcomes. Structured properly, participants gain an understanding and acceptance of the value of the product during their working years that allows them to more easily convert to annuity payments at retirement. Also, when income projections are provided to participants on their quarterly statements, it helps participants view their retirement plan accumulation as a future retirement income stream that they can't outlive. For plan sponsors, this provides the opportunity for communicating a DB-like future retirement income for their DC participating employees.

There are a wide range of retirement income options available to consumers, with and without lifetime guarantees. Each option has its own set of advantages and disadvantages. The key is to ensure that the options are not overwhelming to participants and that proper education and third party advice are provided within the plan to help facilitate better decision making and utilization. The table in the appendix lists the income options commonly available today and attempts to provide a comparative view of their advantages and disadvantages.

Consumer Considerations

There are many macro challenges that can impact the future retirement income needs of an individual - inflation, rising health care costs, and improving life expectancies to name a few. There are also many individual factors that go into a consumer's decisions regarding which income option, or combination of options, are right for him or her. Below are some of the questions that should be considered:

1. What are all of the funding sources of income for retirement and what are their various tax statuses?
2. How soon does income need to begin?
3. Is there accumulated debt that needs to be covered?
4. What is the level of expenses expected to be incurred to meet basic needs in retirement?
5. Will the individual re-enter the workforce periodically after beginning retirement?
6. Will the combination of Social Security and any Defined Benefit pension be sufficient to cover the estimated expenses for basic needs throughout retirement?
7. Beyond expenses for basic needs, what is the desired level of lifestyle and is it expected to be different in different phases of retirement?
8. Are there other people that will depend on the retiree's income and for how long?
9. Will the need for dependent income be expected to extend beyond the retiree's life?
10. Does the retiree have beneficiaries to whom he/she wants to leave assets, including charities?
11. How is the retiree's health and is there insurance beyond Medicare to cover health expenses?
12. If a lifetime annuity is well-suited to the retiree's retirement goals, is a fixed or variable annuity (or both) most appropriate?
13. If a lifetime annuity is appropriate, does the individual live in a state where a Guaranty Association will cover the amount of the annuity income in the event of an insurer insolvency (note there are limits to this coverage that varies by state)?

Given that the combination of various macro and personal factors creates a unique and individualized situation for each and every retiree, most individuals lack the education and skills required to assess their retirement risks and navigate the myriad of choices and decision factors they face. Since the decision to commence lifetime income payments is typically irrevocable in most cases, individuals should consult with a professional advisor to help them analyze their individual situation, make a plan, and determine which combination of available income options best address their individual needs and concerns for retirement.

Plan Sponsor Considerations

Plan sponsor considerations regarding income options depends on whether income options are provided as "out-of-plan" options or "in-plan" options. At TIAA-CREF, we believe that low cost, in-plan annuities are an important part of a retirement plan and we have structured our primary offering around this approach.

With the replacement of DB plans with DC plans, employers have for the most part removed themselves from the financial challenges and responsibilities associated with the funding of lifetime retirement income benefits for their employees. Some argue however, that employers should still retain some responsibility for ensuring that their employees are prepared for receiving an adequate retirement income. This argument gets complicated with the mobility of the American work force where research indicates that many employees will enter retirement having changed employers 5-10 times over a 40 year career[4]. So who should bear the responsibility for the employee's retirement income adequacy – the employee? The last employer before retirement? The employer for whom the employee worked the longest? What about employers that offer no retirement plan? A complicated issue indeed.

Out-of-Plan Options

In this case, Plan Sponsors only take responsibility for providing employees retirement savings tools through the accumulation phase. At the point of retirement, employees must take their accumulated assets out of the plan and are left to make their own decisions on how best to deal with turning those savings into retirement income. The plan sponsor may provide education for employees while they are in the plan to help them understand retirement risks, and may even offer a list of income alternatives and providers that the employee can pursue on their own. But the plan sponsor does not get involved in the retirement income decision making process and once the employee transfers their assets out of the plan, the employer has no further responsibility.

Some questions Plan Sponsors in this case need to consider:

1. Given the employer's mission and values, what do they consider their responsibility to retiring employees?
2. What is the potential reputation risk in the event that a former employee runs out of income during retirement?
3. How much pre-retirement education and guidance on retirement risks and income options should be provided, at what cost, and who should pay?
4. Should a list of income options and providers be provided, and if so, is there a fiduciary responsibility in providing the list?
5. Are the retail prices that retirees pay for their income options fair and should the plan sponsor care?

6. When retiree assets are removed from the plan, how are administrative fees and overall plan economics affected (keeping assets in the plan can help keep administrative fees down)?

In-Plan Options

With in-plan income options, the plan sponsor is faced with the fiduciary responsibility of selecting and monitoring the income options offered and their providers. In addition, the ongoing administrative aspects of providing in-plan income options requires more employee education and means more potential customer service problems between service providers and retirees, which can come back to the employer for arbitration and resolution. Another challenge is the fiduciary responsibility to assess the "reasonableness" of fees for the options offered, which may require the help of a third party consultant, possibly adding to the cost of plan administration. However, most consultants today have been primarily involved in the 401(k) market where the focus is on investment options for accumulating assets and the use of annuities is rare.

Some questions Plan Sponsors in this case need to consider:

1. Does the benefit of providing employees with options that ensure they will have an income they can't outlive offset the added complexity plan sponsors may experience?
2. Does the benefit to plan economics for keeping retirement assets in the plan by offering in-plan income options offset the risk of ongoing fiduciary responsibility for employees through their retirement years?
3. How will the plan sponsor satisfy fiduciary responsibilities in the selection of income options and their providers, particularly for lifetime annuities (i.e. rely on DOL "safe harbor" or "Prudent Man Rule")?
4. Should multiple providers be engaged to reduce single provider risk? Or, can single provider risk be reduced by only offering products and providers that provide full transferability of assets in the event a provider needs to be replaced, even if the costs are higher and value to retirees is lower?
5. What does the plan sponsor need to be prepared to do in the event of a provider insolvency?
6. How much pre-retirement education and guidance on retirement risks and income options should be provided, at what cost, and who should bear the cost?
7. Should the plan sponsor insist on education and advice/guidance being objective and unbiased (i.e. no commissioned sales incentives to the advisors)?
8. Is the employer capable of servicing ongoing income payments, or does it need to be outsourced?
9. Is the employer prepared for backlash from retirees who suffer poor customer service from outsourced income providers?

Conclusions

Participants in DC plans are generally unprepared for the overwhelming risks, choices, and decision factors they need to consider regarding their retirement income. The complexity of the combinations and uniqueness to each individual is beyond a typical consumer's ability to assess. Left to their own devices, experience indicates that poor decisions will be made by many individuals regarding their retirement savings and ultimately, an inadequate retirement income will result.

Likewise, Plan Sponsors face the difficult decision of whether to offer in-plan income options with the associated fiduciary responsibility for which they are generally unprepared, or leave retiring employees to their own devices and decisions which will likely lead to undesirable retirement outcomes.

Today, there are a variety of market solutions available to meet the individualized income needs of retirees, but few can guarantee[5] an income that cannot be outlived. With appropriate education and guidance prior to retirement, combined with clear fiduciary guidance (and potentially some relief for the provider and product selection decisions) from the DOL to help encourage greater use of lifetime annuities as a component of retirement income solutions, both employers and employees can have more confidence in better retirement outcomes.

Finally, low cost in-plan annuity options combined with objective education and advice should be considered keys to providing better retirement outcomes for participants in retirement plans of the 21st century.

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[1]The 2008 Annuity Market, Sales and Assets, LIMRA 2009

[2]" The Problem with Living Too Long", Reish, Ashton and Barnes, Institutional Retirement Income Council, 2010

[3]TIAA Institute, internal research

[4] "Employee Tenure in 2010", Bureau of Labor Statistics, U.S. Dept. of Labor, September 14, 2010

[5]All guarantees provided under lifetime income options are subject to the claims paying ability of an issuing insurance company.