Defined contribution plan design: facilitating income replacement in retirement

For plan sponsors, facilitating the ability of defined contribution (DC) plan participants to generate income for retirement from the plan may be as important as any program enhancement they make. Since most experts believe workers will need 65 to 85 percent of their pre-retirement income in order to maintain their standard of living in retirement, one of the toughest challenges for a DC participant is figuring out how to turn their retirement savings into income they can't outlive.

As we noted in our white paper entitled “DC Plan Design: Why Income Should be the Outcome,” changing a retirement plan’s ultimate focus from savings to income can begin to create the frame of reference necessary for sponsors to offer, and for participants to select, guaranteed retirement income.

An important consideration for DC plan sponsors is determining whether or not retirement income solutions should be considered as a component of a DC plan and, if so, in what way. Plan sponsors approaching this stage should answer the following questions for their organizations:

- Would you like to offer your employees the guaranteed retirement income benefits of a defined benefit (DB) pension, but cannot incur the liabilities of doing so? Or, if you currently offer a DB plan, have you made, or are you planning to make, changes to your plan that would create a greater need for DC plan participants to create retirement income?
- Do you agree with the notion that part of the core purpose of a DC plan should be to serve as an income source during retirement?
- Are you open to the idea that offering only lump sum or systematic withdrawal distributions may not always be in the best interest of your retirees, given the likelihood they could outlive their savings?
- If you introduce a retirement income solution to plan participants, are you prepared to support the program with a robust income-focused educational campaign?
• Do you want your plan participants to have access to institutionally-priced retirement income options?

If the answer to any of these questions is “yes” or even “maybe,” then it may be prudent for you to consider adding a guaranteed income form of benefit payment to your company’s DC plan.

**Evaluating retirement income approaches**

MetLife’s research shows that a large majority of plan sponsors surveyed (85%) agree that the core purpose of a DC plan should be to serve as an income source during retirement.²

An evaluation of the various ways in which a retirement income benefit can be offered as a component of a DC plan today includes:

• the plan sponsors’ understanding of their participants’ pre-retirement income levels and retirement savings;

• the company’s optimal retirement patterns; and,

• the role the DC plan would need to play to facilitate participant retirement.

A participant’s individual needs in retirement, including expected living and health expenses in retirement, and the amount of income they need to replace in retirement, will likely dictate, to a large extent, their interest in any retirement income features added to the plan.

It may be helpful to think of each type of retirement income option available today as a spectrum that ranges from maximum income flexibility to maximum income guarantees. On this spectrum, for example, a systematic withdrawal plan would be at one end of the spectrum and an immediate or deferred fixed income annuity would be at the other end.
In other MetLife research, when plan sponsors were asked which was closer to their own view when they thought about retirement income — systematic withdrawal payments or guaranteed lifetime income payments — 67% of plan sponsors said they think of retirement income in terms of a “draw down” or “systematic withdrawal” program (SWiP) approach. This is consistent with the current thinking of DC plans as savings and investment vehicles, as SWiPs are a natural extension of this frame of reference.

As such, SWiPs were the retirement industry’s initial attempt to introduce some form of structure or planning into the DC distribution process, but a closer look suggests that a SWiP approach, particularly if it is the only approach provided in the plan, can be problematic for a number of reasons, including the following:

- **Impact of market returns and interest rates on a drawdown strategy** — For decades, many financial planning professionals have suggested that individuals limit their annual withdrawals to no more than 4% which, on its face, may seem fairly conservative. Recently, however, this 4% “rule of thumb” has been called into question by several academic researchers, noting that its assumptions were based on returns seen in the 20th century and do not take into account today’s relatively low interest rate environment. For example, a white paper entitled “The 4 Percent Rule is Not Safe in a Low-Yield World” concluded that “financial advisors relying on the classic ‘4% rule’ for their clients’ retirement income have a better than even chance of failure.”
• **Exposure to longevity risk** — DC plan design and practice have resulted in virtually all plan participants either taking their retirement savings as a lump sum distribution or leaving it in the plan until distributions are required under the required minimum distribution (RMD) rules. With the former, far too few participants understand that this approach leaves them extremely vulnerable to longevity risk since they do not know how long they are going to live and, hence, cannot ensure that a drawdown strategy will make their money last for the 20 to 30 or more years that they may spend in retirement. It also leaves them more vulnerable to inflation and market risk. For the latter, by taking only the required minimum distributions, participants may not be taking full advantage of the potential to generate income with what they have saved.

• **Lack of guarantees** — In general, when an employer-sponsored plan offers installments or systematic withdrawals, it utilizes IRS life expectancy tables to determine the level of benefit to the participant. For example, if the participant’s life expectancy at retirement is 20 years, the installment benefit would equal the individual’s plan balance discounted by a stated interest rate for 20 years, based on the assumption of a specific rate of return. Once the individual reaches his or her life expectancy, the benefit ceases because the assets have been completely drawn down. Clearly, such an arrangement poses problems for those people who outlive their average life expectancies, which by definition, 50% of participants will do. Systematic withdrawals have the same shortcoming. Should market performance not equal or exceed the rate used in the withdrawal assumptions on a consistent basis, account balances could become depleted well before the end of retirement.

**A SWiP approach can be most effective when it is used in combination with a guaranteed source of income, such as an immediate income annuity or a deferred income annuity — e.g., longevity insurance.** The combination of a SWiP and guaranteed income can enable participants to both manage their retirement savings to a defined time horizon and have the benefit of a steady, guaranteed income stream that they cannot outlive. With longevity insurance, which is a deferred income annuity that could be purchased at the point of retirement, but would not begin payments until the individual reaches an advanced age (e.g., age 80 or 85), the individual can address their longevity risk while managing their remaining assets for a limited time horizon. This allows the individual to have guaranteed income later in life when it may be needed most, while also making it easier to determine exactly how much money can be withdrawn from their savings each month.
Navigating complexity and innovation: withdrawal solutions with guarantees

In recent years, the qualified retirement plan industry has seen the emergence of many new products along the retirement income spectrum as providers seek to find features and positioning that will meet emerging plan needs and participant preferences. At the same time this competition and innovation around retirement income solutions has the potential to create significant confusion for both sponsors and participants.

Sponsors may be well-advised to first clearly establish the outcome they want to achieve or facilitate and then keep it firmly in mind as a guiding principle for plan design considerations. Plan sponsors may also want to consider adopting a “Retirement Income Policy Statement,” which would outline the retirement income options available to their participants. This could be similar to the now widely used “Investment Policy Statement,” which most plan sponsors use as a guideline for their investments. Determining which type of solution to offer should come after the decision has been made to re-establish the DC plan as a retirement plan whose intent is to help participants generate retirement income.

One area of experimentation, first in retail and more recently in the institutional retirement arena, is a product category called guaranteed lifetime withdrawal benefits (GLWB) that combines systematic withdrawal with a potential income guarantee. As these features require a variable product, this type of product is often structured as a DC plan investment that can guarantee a fixed withdrawal amount regardless of the actual account balance at retirement. However, withdrawals over a stated amount and other participant actions may reduce the guaranteed withdrawal amount, and while many participants and sponsors may find the concept of these guarantees attractive, the products may be difficult for the average participant to understand and complicated for sponsors to successfully communicate.
<table>
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<th>Feature</th>
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<th>Income Annuity⁷</th>
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*Excess withdrawals may affect guarantee
**If cost of living adjustment (COLA) rider is chosen

Providing income with fixed income annuities

Deferred and immediate income annuities provide individuals with an income stream that cannot be outlived — period. This type of guarantee can only be achieved with an annuity. Annuities, like all insurance products, work on the concept of pooling risks which, in the case of retirees, include longevity, investment and inflation risks. The pooling of risk is not new to most people. For generations, Americans have held the majority of their retirement assets in a risk pool. Social Security and corporate pension plans are both examples of mortality pools. When an insurer pools longevity risk for a large group of retirees, money that is left over from people who die earlier than the average life expectancy is used to continue to pay people who outlive the average age. Pooling works because everyone shares a common risk, and while it can be accurately predicted how many people will be adversely affected by the risk, it is not possible to know in advance which specific individuals they will be. Through the use of pooling, monumental efficiencies take place: for example, an average retiree would need to save about one-third more to replicate the protection a large group makes possible.⁸ An annuity should be considered to fill any gap that exists between the level of fixed living expenses and the amount of guaranteed income provided by sources such as Social Security or a monthly pension payment.
An income annuity is an insurance product, and should not be considered an investment alternative, but a complement to other sources of retirement funding. Mutual funds and other investments play an essential role in retirement as they provide liquidity and possible asset growth that can help offset inflation. However, as well as being vulnerable to market volatility, the income they provide may run out if one lives longer in retirement than anticipated. By allowing plan participants to place part of their retirement savings in a fixed income annuity, they will be able to generate income that lasts a lifetime, manage their remaining assets more efficiently, and maximize and protect their future income. Consider the following: “For each dollar a retiree shifts from bonds to immediate annuities, $0.56 is available for additional spending. If all assets were shifted to an immediate annuity, spending would increase by 56% relative to a bond-based spending program.”

This type of approach does not seek to address all of these objectives in a single product, but permits the participant to break the decision down into separate steps.

The value of keeping it simple for plan participants

For a sponsor wishing to provide guaranteed lifetime income from a DC plan, it is in the best interests of plan participants to keep it simple. While it may be tempting for plan sponsors to believe they should alleviate potential participant objections by offering products with many features, simplicity has proven to be a more effective guiding principle for the decision-making process. This is important because participant behavior has consistently shown that complexity, such as too many choices and features, often leads to participant inertia (i.e., avoiding taking any action).

For this reason, beginning with a “back-to-basics” approach when considering guaranteed retirement income options may be the most constructive strategy. The majority of plan sponsors agree with this approach. In fact, nine in ten plan sponsors (90%) believe that it is in the best interests of plan participants to keep plan design changes simple since complexity, such as too many choices and features, often leads to participant inertia (i.e., avoiding taking any action).
As a final consideration, the emerging wealth of behavioral research suggests that how a decision is framed — e.g., the way in which it is perceived by participants — may be the most significant determinant of its outcomes. For example, “life annuities are more attractive when presented in a consumption frame rather than an investment frame,” meaning that individuals are more likely to recognize the benefits of a guaranteed stream of income when the focus is on the purchasing power this income stream can provide, rather than on risk and return features, such as principal guarantees.

By adding a guaranteed retirement income element to their plans, sponsors can know that they have done everything possible to help participants achieve their retirement income goals and enjoy a more secure retirement.

Please contact your MetLife representative or call 1-877-638-2862 if you would like to discuss these ideas in greater depth.

1. The Retirement Crisis and a Plan to Solve it, U.S. Senate Help Committee, 2012
2. MetLife 2016 Lifetime Income Poll
3. MetLife’s 2012 Retirement Income Practices Study
5. We note further that the authors elaborated on this research in a Morningstar whitepaper entitled “Low Bond Yields and Safe Portfolio Withdrawal Rates.” using a new model it developed, which “takes into account current bond yields when determining the success of different initial withdrawal rates,” Morningstar has concluded that “safe initial withdrawal rates” (i.e., the initial percentage withdrawn from the portfolio) are actually lower than previous research has indicated, in which a 4% initial withdrawal rate was considered “safe.” According to Morningstar, the 4% initial withdrawal rate may not be viable in a low interest rate environment.
6. Guaranteed Lifetime Withdrawal Benefit refers to a variable annuity contract with a rider or feature that provides a withdrawal amount independent of fund value, within defined parameters.
7. Either a Deferred Income Annuity (DIA) or Immediate Income Annuity (IIA); both are fixed annuities.
8. Letter from C. Robert Henrikson, (former) President and Chief Executive Officer, MetLife, to President Bush and Members of the 108th Congress, September 7, 2004
10. MetLife 2016 Lifetime Income Poll

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