Are DC Plans Ready for a Retirement Income Makeover?

As our nation continues its transition away from defined benefit (DB) plans to a predominantly defined contribution (DC) retirement system, guaranteed lifetime income must be recognized as the crucial unfinished chapter in the 401(k) narrative. This article discusses policy makers’ growing sentiment for retirement income, why DC plans need a retirement income makeover and the reasons lifetime income provisions in the Lifetime Income Disclosure Act of 2017 (LIDA) and the Retirement Enhancement and Savings Act of 2016 (RESA) deserve public policy consideration.

by Cynthia Mallett | MetLife and Roberta Rafaloff | MetLife

If the architects of the 401(k) could return to the drawing board, what might they design differently to ensure better retirement outcomes for U.S. workers? After nearly four decades as a retirement savings vehicle, the defined contribution (DC) plan is on the cusp of a much-needed makeover as policy makers are being called upon to light a clearer fiduciary path for lifetime income solutions. Once available to many workers through a defined benefit (DB) plan, guaranteed lifetime income is increasingly identified as a critical missing link in DC plans—which today serve as the backbone of the U.S. retirement system. According to the co-author of recently proposed legislation, “We must make the 401(k) a better solution for income.”

Navigating the fiduciary and administrative complexities associated with offering lifetime income solutions, such as annuities, within DC plans has been a legal tightrope few plan sponsors have felt comfortable walking. In recent years, policy makers have responded to calls from lifetime income proponents by proposing legislation and regulation that would provide sponsors their long-sought fiduciary safety net and basic regulatory guidance, but proponents say there is still more work to be done.

Policy Makers’ Growing Sentiment for Retirement Income

Efforts by the Obama administration to help Americans “retire with dignity” led to a wave of initiatives aimed at making lifetime income more accessible to participants in DC plans. Among the lifetime income initiatives completed under President Obama are Treasury Department final regulations from July 2014 providing for qualifying longevity annuity contracts (QLACs), separate revenue rulings that allow for the partial annuitization of DC account balances via rollover to a DB plan and the ability to offer a deferred annuity contract as an investment option within a target-date fund.

Given what we know today about longer life expectan-

cies—coupled with the need to strengthen retirement securi-
ty for millions of U.S. workers—policy makers from both sides of the aisle are coming together to explore solutions for addressing the financial implications of living to the age of 90, 100 or even beyond.

On April 6, 2017, bipartisan members of both the U.S. House of Representatives and the U.S. Senate reintroduced the Lifetime Income Disclosure Act (LIDA), which would require the inclusion of monthly income projections on 401(k) account statements.

The Retirement Enhancement and Savings Act of 2016 [S. 3471] (RESA), which was the final bill to address lifetime income during the Obama administration, had been unanimously approved by the Senate Finance Committee in September 2016. It aimed to deliver the safe harbor protections that DC plan sponsors have long been seeking regarding the use of annuities as lifetime income options, plus additional measures that would have facilitated lifetime income for workers.

RESA included, among a number of other retirement policy proposals, a trio of provisions that would have (1) given plan sponsors fiduciary certainty regarding the selection of a lifetime income annuity provider, (2) required lifetime income estimates on participant benefit statements and (3) made income solutions, such as annuities, more portable.

Why DC Plans Need a Retirement Income Makeover

The 401(k) has been a work in progress almost since its inception, with policy makers pivoting quickly at times in response to challenging economic and market conditions. The introduction of automatic features and target-date funds, for example, which grew in popularity as a result of the 2006 Pension Protection Act, helped to improve participation and deferral rates and make the DC plan a more effective vehicle for accumulating retirement assets. But now that the first generation of DC participants is entering retirement, it is painfully apparent that, although asset accumulation during one’s working years and income during retirement may be complementary goals within the DC structure, they are by no means synonymous.

“It’s not only getting to retirement, it’s living through retirement,” commented Kent Conrad, former Senate Budget Committee chairman, on work underway by the Bipartisan Policy Center (BPC). Founded in 2007 under President Bush, the BPC is a strong advocate for incorporating lifelong income solutions (vis-à-vis annuities because of their guarantees) in both employer- and state-sponsored retirement plans.

“[E]ven after a lifetime of saving, retirees face another problem—making their assets last through a retirement that could be two or three decades or longer,” said BPC Senior Policy Analyst Brian Collins. “Increasingly, workers are retiring with a large pot of cash and no guarantee that the money will last.”

Further compounding this present situation are participant perceptions that their accumulated values are large. While this may be true relative to a savings account balance, in many cases it is not at all large relative to recurring income needs.

“The great lie is that the 401(k) was capable of replacing the old system of pensions,” says former American Society of Pension Actuaries head Gerald Facciani, who helped turn back a 1986 Reagan administration push to kill the 401(k). “It was oversold.”

The simple truth is that DC plans were never designed for lifetime income and, as such, they often lack a mechanism (e.g., a guaranteed income annuity) through which participants can achieve this objective. Planning for income is uniquely complex and, without a built-in income component like DB plans have, requires a level of financial literacy and a skill set that go beyond the capability of most participants. For example, it is very difficult for the average employee to conceptualize what his or her DC plan balance means in terms of a stream of income for life.

Until recently, efforts to educate DC participants about retirement income planning have taken low or no priority over discussions that were closer to the raison d'être for DC plans—savings! But things are changing.

Plan Sponsors Seek More Lifetime Income Guidance

During the summer of 2016, MetLife conducted a survey to more fully understand the extent to which DC sponsors are ready to recast their plans for income. Of the 212 DC sponsors surveyed for the MetLife 2016 Lifetime Income Poll, 85% agreed that the core purpose of a DC plan should be to serve as an income source during retirement. This represents a dramatic shift from a 2012 MetLife study in which just 9% of respondents reported...
that income (rather than savings) was the primary focus of their plan.7

In view of these findings, it comes as no surprise that, when asked how closely they monitor legislative and regulatory initiatives that will facilitate their ability to offer income solutions, nearly 94% of the surveyed sponsors reported that they are at least somewhat knowledgeable about efforts by the Departments of Labor (DOL) and Treasury over the last several years to strengthen U.S. retirement security through lifetime income solutions—including 45% who said they are extremely or very familiar with these efforts.8 Encouraging workers to consider guaranteed lifetime income options—for example, the availability of longevity insurance and partial annuitization—represents sound public policy, according to six in ten (62%) survey respondents.9

**Lifetime Income Trio Deserves Public Policy Consideration**

The trio of provisions included in RESA would have a meaningful impact on plan participants by helping them better understand their need for retirement income and, at the same time, enabling employer actions to increase the availability of lifetime income solutions at the workplace. It also would begin to recast DC plans as retirement income programs. Specifically, lifetime income illustrations would help to redirect participants away from a mindset focused on monthly contributions to one that is grounded in the purchase of future retirement income. In addition, clarification of the safe harbor for annuity carrier selection and lifetime income portability, as set forth under RESA, would facilitate more successful retirement outcomes by increasing the availability of lifetime income solutions at the workplace and making it easier for distributions to be taken as an individual retirement account (IRA) or an annuity without having to ensure that it’s a distributable event. Below is a description of these provisions.

For many individuals, the reality of retirement isn’t necessarily aligning with the dream—and inadequate savings are just part of the story. The fear by employees that they haven’t saved enough is compounded by the realization that they may live longer than they thought and what they have amassed won’t last. Running out of money is employees’ biggest concern about retirement, followed by health issues and health care costs.10 Not surprisingly, 80% of participants in DC plans say they would consider purchasing lifetime income guarantees similar to those the DB plan once offered their parents,11 and 67% would be willing to take less in pay increases in exchange for guaranteed income in retirement.12

**Lifetime Income Disclosures**

The RESA legislation and, more recently, the LIDA bill, would require benefit statements provided to DC plan participants to include a lifetime income disclosure at least once during any 12-month period. The disclosure would illustrate the monthly payments the participant would receive if the total account balance were used to provide lifetime income streams, including a qualified joint and survivor annuity for the participant and the participant’s surviving spouse and a single life annuity. The secretary of labor is directed to develop a model disclosure. Disclosure in terms of monthly payments will provide useful information to plan participants in correlating the funds in their DC plan to lifetime income. Plan fiduciaries, plan sponsors or other persons will have no liability under the Employee Retirement Income Security Act (ERISA) solely by reason of the provision of lifetime income stream equivalents that are derived in accordance with the assumptions and guidance under the provision and that include the explanations contained in model disclosure.13

DC participants commonly make financial decisions during their working years based on their monthly or annual income. Yet many participants make decisions about retirement without this information, since most have no idea what their income will be once they retire. While online tools are available, retirement income projections are not routinely provided to plan participants today on statements that summarize their total and vested account balances, nor are they automatically shown to participants when they view their account balances online. According to the MetLife Retirement Income Practices StudySM: Perspectives of Plan Sponsors and Recordkeepers for Qualified Plans, only one-third of large plan sponsors (33%) and six of the 12 largest recordkeepers that service primarily Fortune 500 companies report that they include retirement income projections on participant statements. Similarly, only 28% of plan sponsors and the same six recordkeepers say that retirement income projections automatically are shown to participants when they view their account balances online.

Much like the projected benefit statements issued by the Social Security Administration, simple and standard-
ized lifetime income illustrations, when presented by DC plan sponsors in easy-to-understand language, can be one of the most instructive tools provided to participants. “Over time, this change [lifetime income disclosures] may help encourage account owners to become accustomed to thinking of their retirement resources as monthly income.”

The real issue here is not about the income illustrations per se. Rather, showing participants how their account balances today translate into a monthly income—one they are “purchasing” for their future—can drive a fundamental shift in the way they save, how they plan for income and, ultimately, how committed they are to the plan. Providing such basic information would enable participants to better understand how their Social Security and DC plan benefits could work together, as DB plans used to do automatically. This also would likely generate more participant interest in using the online tools provided by plan sponsors and/or their recordkeepers.

Nearly all plan sponsors surveyed in the MetLife Lifetime Income Poll (96%) agree that it would be helpful for plan participants if account balances shown on benefit statements were required to also be communicated as lifetime income—including 62% who believe it would be extremely or very helpful for plan participants. Research also points to the fact that participants would welcome lifetime income illustrations. More than eight in ten respondents (85%) contributing to an employer-sponsored retirement plan believe an illustration similar to the lifetime income estimate calculator produced by DOL would be useful, according to the Employee Benefit Research Institute 2014 Retirement Confidence Survey, which polled 1,000 workers and 501 retirees.

Depending on legislation passed and signed into law and/or regulations promulgated on lifetime income disclosures for DC plan benefit statements, there are a number of specific approaches for plan sponsors to consider. Uniform adoption of these assumptions by the industry would be preferable, due to frequent job changes by younger workers.

- **Normal retirement age.** Basing disclosures on a standard age that can be kept constant over time is preferable. The age of 65 has become ingrained in our society as the traditional retirement age and works for both active and former plan participants. Using a projected retirement age older than 65 could inadvertently have an adverse effect on an individual’s retirement planning efforts. The one exception would be for plan sponsors that have a formal standard retirement age that differs from the age of 65, in which case an employer should be able to use the age included in the plan document as an alternative to the general aged-65 rule without losing the safe harbor benefits.

- **Investment return assumption.** A 4% after-inflation rate of return is reasonably conservative but still high enough to incentivize participants to save in their DC plans, and it may be a more stable investment assumption that will require less vigilance in revisiting and updating.

- **Inflation.** Since many plan participants do not properly understand the concept of inflation, it may be prudent to include an explanatory note in a lifetime income projection with language such as the following: “Your projected savings and their income equivalent are not adjusted for the effects of future inflation. Your expenses in the future are likely to be higher than they are today due to the impact of inflation over time. Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling. As inflation rises, every dollar will buy a smaller percentage of goods or services.”

- **Converting an account balance to lifetime income.** We believe that an annuitization approach is preferable to using a drawdown or systematic withdrawal program (SWiP) approach. If participants rely on a SWiP as the sole method for trying to make their money last throughout their lifetimes, without the protection of an income annuity or longevity insurance, there still is significant risk that many of them would run out of money.

**Fiduciary Safe Harbor for Selection of Lifetime Income Provider**

The RESA legislation provides certainty for plan sponsors in the selection of lifetime income providers, a fiduciary act under ERISA. Under the bill, fiduciaries are afforded an optional safe harbor means to satisfy the prudence requirement with respect to the selection of insurers and guaranteed retirement income, which would protect them from liability for any losses that may result to the participant or beneficiary due to the inability of an insurer in the future to satisfy its financial obligations under the terms of the contract. Removing ambiguity about the applicable fiduciary standard eliminates
a roadblock to offering lifetime income benefit options under a DC plan.\textsuperscript{15}

For more than a decade, regulatory initiatives have sought to address and clearly define for DC plan sponsors their liability risk when offering annuities as an income generation strategy. In September 2016, the Government Accountability Office (GAO) released a report recommending actions the DOL could take to improve retirement income options for DC plan participants. Of the 54 DC plan sponsors surveyed for the GAO study, 39 did not offer an annuity, and 26 of them said “their decision was influenced by the resources required to obtain liability relief.” The report further explained that the fiduciary safe harbor protections promulgated in 2008 DOL guidance weren’t helpful, in that they did not set forth the clear criteria that sponsors were looking for.\textsuperscript{16}

Findings from the MetLife Lifetime Income Poll show that the fiduciary safe harbor is a more significant concern for sponsors than was uncovered by the GAO. Nine in ten plan sponsors (92\%) surveyed for the MetLife study agree that it is important for the DOL to provide a workable safe harbor for annuity carrier selection criteria for individual account qualified plans in order to make it easier to include income annuities in their DC plans—including 70\% that think it is extremely or very important. This percentage rises to 96\% among those that say they are at least somewhat familiar with proposed amendments to the annuity safe harbor carrier solvency determination requirement, primarily focused on the condition of the safe harbor relating to the ability of the annuity provider to make all future payments under the annuity contract.

More than one-third of plan sponsors (37\%) agree that solvency determination (i.e., evaluation of the annuity provider to ensure that its solvency is adequate to make all future payments to the annuitant(s)) is the most pressing issue that still needs to be addressed to ensure a workable safe harbor. This rises to 47\% among those that are extremely or very familiar with proposed amendments to the safe harbor. Three-quarters (76\%) of respondents say that in determining the adequacy of the solvency of a potential annuity provider for their DC plan, they would prefer to be permitted to rely on certifications from the annuity provider based on the regulatory process carried out by a state insurance commissioner rather than to conduct the solvency due diligence process themselves as part of their regular due diligence process for plan providers.

It is important for a distinction to be drawn between carrier selection, which is the subject of the safe harbor, and product selection, which remains subject to all of the usual fiduciary considerations in accordance with ERISA.

A proposal was put forth by the American Council of Life Insurers (ACLI) that "would allow the fiduciary to rely on a certification by its chosen carrier that it has met certain standards with respect to state insurance commissioner review. The [insurance] carrier would have to be licensed in 26 or more states, to prevent ‘forum shopping.’ [The insurer] would have to have a clean certificate of authority from its home insurance commissioner, audited financial statements and reserves that satisfy the requirements of all states where it does business; also, [the insurer] could not have operated under an order of supervision, rehabilitation or liquidation. In addition, the [insurance] carrier would have to undergo a financial examination by the insurance commissioner of the domiciliary state at least every five years.”\textsuperscript{17}

### Lifetime Income Portability

RESA legislation permits qualified DC plans, Section 403(b) plans or governmental Section 457(b) plans to make a direct trustee-to-trustee transfer to another employer-sponsored retirement plan or IRA of lifetime income investments or distributions of a lifetime income investment in the form of a qualified plan distribution annuity, if a lifetime income investment is no longer authorized to be held as an investment option under the plan. The change will permit participants to preserve their lifetime income investments and avoid surrender charges and fees.\textsuperscript{18}

Concerns about the portability of in-plan annuities have discouraged some DC sponsors from offering these income products in their investment menus. Even with the development of the middleware that would connect the platforms of recordkeepers and product providers, not all recordkeepers have made the investment in the technology. Absent a way to transfer an existing annuity from one employer plan to another, a participant would need to liquidate the annuity contract and thus forfeit the guaranteed benefit.

Under RESA, plan participants would be allowed to take a distribution of a lifetime income investment without regard to the restrictions on plan withdrawals prior to a distributable event, i.e., death, disability, the age of 59½, termination of employment, etc.
Conclusion

The 401(k) is long overdue for an income makeover. As our nation continues its transition away from DB plans to a predominantly DC retirement system, guaranteed lifetime income must be recognized as the crucial unfinished chapter in the 401(k) narrative—without which the DC plan simply cannot fulfill its mandate of providing financial security for U.S. workers. From Washington to corporate America, reframing the 401(k) for lifetime income should be on everyone’s agenda. It won’t necessarily be easy to implement, as considerable plan design effort and organizational resolve will be required—but it also won’t be optional if the 401(k) is to remain relevant for helping workers achieve better retirement outcomes. It is just a matter of time until a coherent regulatory and legislative framework catches up with the need to reframe the DC plan for income.

Endnotes
1. Sen. Orrin Hatch, R-Utah, Senate committee chairman.
4. Ibid.
8. Ibid.
9. Ibid.
11. According to a 2009 MetLife study, eight in ten Americans (80%) report that they are now more concerned with guarantees and stability than they are with investment returns.
17. PLANSPO RROR, “Fixing DC Annuities: There’s a Proposal on the Table,” October 2013.