The Retirement Income Menu: An Idea Whose Time Has Come

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The following article is written by Steve Vernon, an IRIC® member and president of *Rest-of-Life Communications*. The Council encourages active dialogue regarding ways to help defined contribution participants achieve a secure retirement. The article reflects Steve's personal views that may or not be shared by other members of the IRIC council. Some of the views are aspirational in nature and related legal issues would need to be addressed.

Joe, a controller at a Fortune 500 company, retired at age 65 with a substantial lump sum payment from his employer. It seemed like a lot of money at the time, so Joe invested these assets and took out whatever he needed, whenever he needed to meet his living expenses. In spite of his financial background, Joe didn't manage his savings well – the money ran out by the time he was 75. Now his house has been foreclosed on and he's working as a delivery driver to make ends meet.

Mary also retired at age 65 with a substantial 401(k) account. However, her employer realized that retiring employees often had difficulty deciding how to generate reliable lifetime retirement income; as a result, the company had analyzed many methods and products for generating retirement income, and offered retiring employees a menu of seven choices for this purpose. The options were accompanied by a robust educational program on the pros and cons of each method. After careful consideration, Mary applied part of her account balance to purchase an immediate annuity, and invested the remainder, which she is drawing down cautiously so that the odds of outliving her savings are low. The 401(k) plan administrator implemented Mary's choices after she made her elections online. Mary feels good about her retirement security – she's smart about managing her living expenses to match her lifetime retirement income. She can now turn her attention to enjoying her retirement.

The first story is true – it happened to a family friend (although the name has been changed). The second story is fictional, although I'm optimistic that Mary's story will become a common one during the next decade.

I strongly believe that defined contribution plan (DC) sponsors should offer their retiring employees a limited menu of various methods to generate retirement income from their account balances. A properly designed and communicated retirement income menu addresses a serious challenge that's developed from the transition to defined contribution (DC) plans as the primary employer-sponsored retirement program:

> *How do retiring employees generate reliable sources of lifetime retirement income from their defined contribution account balances?*

There are many similarities between the investment menu that exists in the accumulation phase, and the retirement income menu that can be made available for the payout phase.

To get started, let's review the challenges that the retirement income menu addresses, see how it can work and address the various issues regarding design, implementation, communication and compliance.

The Retirement Income Challenge of Defined Contribution Plans

Over the past three decades, employers in developed nations around the world have shifted from defined benefit pension plans to defined contribution plans as their primary system for delivering retirement security to employees. This places the responsibility for investing account balances during their working career – known as the accumulation phase - directly on employees. To help address these challenges, many plan sponsors and their plan administrators have designed and implemented investment menus that are accompanied by robust educational programs.

But there's another consequence of the defined contribution system that historically did *not* get the attention it deserved, and that's the period during retirement, when retired employees are responsible for investing and drawing down their account balances.

The fact is, most employees lack the time and skills to make effective and informed decisions on generating retirement income from their account balances. They're faced with a bewildering array of financial products, institutions and advisors; they typically make choices that may not best fit their situation, or are so paralyzed with fear that they don't make any choice at all.

In addition, many financial advisors are uninformed about the challenges of generating lifetime retirement income, or they have a conflict of interest that prevents them from recommending solutions that are best for the retiree. In both cases, a common, undesirable outcome is that plan participants exhaust their retirement accounts during their retirement years, and face destitution.

Various surveys show that employees need and desire help in this area. For example, the *2011 Retirement Confidence Survey* of the Employee Benefit Research Institute (EBRI) shows that:

- Only 13% of workers surveyed are confident about their ability to retire.
- Only 42% of workers have tried to calculate how much money they need to retire comfortably.
- 91% of workers would find valuable a statement of how much retirement income their accounts could generate.[1]

The *8th Annual MetLife Study of Employee Benefit Trends*, conducted in late 2009 surveying more than 1,300 employees, showed that:

- 61% are planning for a retirement of less than 20 years.
- 55% would like some retirement income from the plan instead of just a lump sum.
- 53% are concerned about outliving their assets.
- 44% would like an annuity option in their plan. [2]

A 2010 Society of Actuaries' report titled *Process of Planning and Personal Risk Management* also surveyed pre-retirees, with the following results:

- 58% are concerned about outliving their assets.
- 39% plan to draw down their savings as needed to cover expenses, with no set plan as to how to do that.
- Only 13% plan 20 years or more into the future when making important planning decisions, yet retirements can easily last 20 years or more. [3]

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[1] "The 2011 Retirement Confidence Survey: Confidence Drops to Record Lows, Reflecting 'the New Normal'". Issue Brief No. 355, March 2011, Employee Benefit Research Institute.

[2] "8th Annual Study of Employee Benefits Trends: Findings from the National Survey of Employers and Employees", MetLife, 2010.

[3] "Key Findings and Issues: Process of Planning and Personal Risk Management", the Society of Actuaries, 2009.

Clearly, generating reliable retirement income is a key concern for employees approaching retirement age. Yet, according to the Profit Sharing Council of America's 2009 *Survey of Profit Sharing and 401(k) Plans*, only 19% of plans offered an annuity option.[4] According to Hewitt's 2009 survey report, *Trends and Experience with 401(k) Plans*, only 14% of 288 plans offered an annuity option, while 55% offered installment payouts.[5] So one or more retirement income options are currently being offered in some defined contribution plans; packaging retirement income options in a menu can be considered a natural evolution from current practices.

The same Hewitt survey reports that upon termination of employment, 84% of participants elect a lump sum, 10% opt for installment payouts, and only 1% elect an annuity. [6] (These statistics most likely are skewed towards participants who terminate employment before retirement.) It's my belief that better packaging of the options and communication about the pros and cons of each payout option would significantly increase the election rate of payout options that generate retirement income, as indicated by the surveys mentioned above about preferences of employees approaching retirement.

Employers have the opportunity to use their skills and resources to design, communicate and implement a retirement income menu that helps employees address the challenges described above. Employees have grown to trust the employer to design, implement and communicate an investment menu -- it's only natural that they would look to their employer to do the same with respect to generating retirement income.

[4] "52nd Annual Survey of Profit Sharing and 401(k) Plans", The Profit Sharing/401k Council of America, 2010.
[5] "Trends and Experience in 401(k) Plans 2009", Hewitt Associates.
[6] Ibid.

Common Retirement Income Goals

Most retirees want a reliable source of income that covers their living expenses, no matter how long they live and no matter what happens in the economy. Let's expand on this goal and include other possible retirement income objectives:

- The account balances need to generate income for a retirement whose length is generally unknown. Retirees don't want to outlive their financial resources.
- The retirement income should keep pace with inflation.
- The retirement income shouldn't reduce significantly due to stock market declines or fluctuations in interest rates.
- Retirees may want access to capital for emergencies.
- Some retirees may desire to leave a legacy to children or charities.

With these objectives in mind, here are two critical, related decisions that retiring employees must make:

- How much money do they need for a secure retirement?
- When can they afford to retire?

Unfortunately, most people approaching retirement don't attempt to make these types of calculations, as indicated by the EBRI survey mentioned previously.

Most employees lack the time or skills to successfully navigate the challenges described above. They often retire with an account balance that looks like a lot of money, so they draw out what they need each year for living expenses, with no plan to make the savings last the rest of their lives. Call it "pay as you go" retirement. Unfortunately, this method doesn't help your money go far enough to last a lifetime for most people.

A properly designed retirement income menu could substantially improve the financial outcomes of retiring employees. So let's turn our attention to details regarding the retirement income menu.

How the Retirement Income Menu Works

Here are the basic features of a retirement income menu:

- Retiring employees would be offered a limited menu of distinct methods to generate retirement income from their account balances.
- The menu would include a lump sum payout and/or a rollover for employees who don't want to use the retirement income menu – similar to the brokerage window for investments. The message of this option: You're on your own.
- Employees could distribute their account balances among more than one method of generating retirement income.
- With some of the retirement income methods, retirees could make changes in their payout method after the income has commenced, as their needs change.
- If the plan elects, a default method would apply to employees who terminate employment without making an election.
- The menu would be accompanied by robust education on the pros and cons of the various methods to generate retirement income, along with modeling tools to show how much retirement income could be generated by each method.
- The plan sponsor would design the menu and communications campaign considering the relevant circumstances of both the employer and its employees, such as products and services available to the plan given its size, employees' financial sophistication, and the plan administrator's administrative capabilities. Periodically, the plan sponsor would monitor the performance of the options and make changes as necessary.

As you can see, there are many similarities between an investment menu and the retirement income menu.

Possible Retirement Income Methods

There are three possible ways to generate retirement income from account balances:

- Invest the retirement savings, and use the investment income – dividends and interest – as retirement income.
- Invest the retirement savings, and draw down principal and investment income carefully, such that retirees have a low chance of outliving their financial resources. This technique can have various names; for the purpose of this paper, I'll use the term "managed payouts," although this may also be called an "installment method."
- Buy an immediate, deferred, or guaranteed withdrawal benefit annuity from an insurance company.

There are many variations on each of the above methods. For example, there are fixed, inflation-adjusted and variable immediate annuities. Managed payout funds can have a payout for a fixed period of years, or they can be "evergreen."

Each of these methods has various advantages and disadvantages.

- Living on interest and dividends preserves retirees' principal and virtually guarantees that they won't outlive their resources. It also allows retirees access to the capital in the event of emergencies, and will provide a legacy to children and charities. However, it generally results in the lowest amount of retirement income, and the money is subject to stock market fluctuations and interest rate declines.

- Managed payouts have the similar advantages and disadvantages of using investment income while providing a higher level of retirement income. With this method, however, retirees are subject to the risk of outliving their savings, and the amount of legacy provided to children or charities is reduced compared to using investment income.

- Annuities address the longevity risk by paying a retirement income no matter how long the retiree lives. And compared to the first two methods, annuities usually have the highest initial amount of retirement income. However, the retiree generally doesn't have access to the capital for emergencies, and there won't be any legacy left to children or charities. The most common form of annuity – a fixed annuity – is also subject to inflation risk, because the amount of retirement income doesn't increase. In addition, the retiree must consider the credit-rating of the insurance company, and what happens to the annuity in the event of insurance company bankruptcy.

A combination of methods might work best for a retiree's specific circumstances. For example, a retiree might take part of the account balance to purchase an annuity to address the longevity risk, and invest and draw down the remainder of the account balance to provide access to capital in case of emergencies.

Also, a retiree might want to change the method of generating income during retirement. For example, a retiree might initially invest the balances and use either investment income or managed payouts to generate retirement income, and years later convert remaining accounts to the purchase of an annuity. Once an annuity starts, however, usually it can't be changed.

Products and Services That Address the Retirement Income Challenge

Many mutual fund companies, insurance companies, and financial advisors are introducing products and services to address these retirement income challenges. Here's a brief review of some of these products and services:

- Many insurance companies offer traditional fixed annuities, and services such as Hueler's Income Solutions provide a bidding service among a panel of selected insurance companies.
- Several mutual fund companies and financial institutions, such as Fidelity, Vanguard, and Schwab, offer managed payout funds that will pay interest, dividends, and principal over specified periods.
- Financial Engines recently announced their *Income +* service, where plan participants can be advised on how to draw down invested assets to provide lifetime retirement income with upside potential to stock market returns - but with no guarantees either.
- Insurance companies such as Prudential, Hartford and Diversified/Transamerica offer Guaranteed Minimum Withdrawal Benefits (GMWBs), that offer a combination of invested assets with a guarantee of lifetime retirement income.
- American General Life offers immediate variable annuities where the monthly benefit is adjusted to reflect investment performance of underlying Vanguard mutual funds.
- Some financial institutions are offering hybrid products that combine managed payouts with longevity insurance (annuities that begin at an advanced age, such as 80 or 85).

The sales pitches for these products and services are predictable: Insurance companies claim that annuities are best, mutual fund companies claim that managed payouts are best, and specialty institutions claim that hybrid products combining the features of annuities and managed payouts are best.

In reality, each of the above products and services has its pros and cons, and each might be the best solution for a certain individual, but none can be the best for all people all the time.

The plan sponsor is in the best position to analyze the various products and services in the marketplace and offer a menu of retirement income options to plan participants. The plan sponsor can advocate on behalf of plan participants and offer unbiased, comprehensive education on the pros and cons of each method.

Robust Communications Program

The plan sponsor and/or plan administrator would provide a robust communications program that would provide:

- Education about the goals that each method meets, such as whether there is a guarantee of lifetime income, and whether it's possible that residual assets might be available for a legacy.
- The related risks of each method, such as longevity risk, inflation risk, and market risk.
- The fees and costs associated with each method.
- The circumstances that might support election of a particular method.

However, the plan sponsor would be careful not to provide advice on which method(s) employees should elect, and should focus on helping participants make informed decisions. One method is to use examples or scenarios of different hypothetical people - their circumstances and why they might select a particular retirement income method. These are the same guidelines and principles that plan sponsors and plan administrators use to communicate the investment menu.

The plan sponsor or plan administrator would also provide participants with modeling tools, so that a participant considering retirement would see how much retirement income could be provided considering his or her circumstances under each of the methods of generating retirement income. This helps with retirement planning and budgeting, and whether the employee can afford to retire.

Should Retirement Income Choices Reside Inside or Outside the Plan?

This question comes up frequently in discussions about the retirement income menu, and the nuances can be subtle. First we need to define what's meant by "inside the plan."

Plan sponsors and professionals with a background in qualified retirement plans will define "inside the plan" as those plan assets that remain in the qualified defined contribution plan during the payout phase. In the United States, that means these assets are counted for the annual Form 5500 filing. "Inside the plan" assets would include:

- Managed payouts that are administered by the plan administrator, and
- Annuities delivered by an insurance policy that is held in the plan's trust, typically a group annuity contract.

"Outside the plan" assets would include:

- Rollovers into IRAs sponsored by mutual fund companies, offering managed payout funds, and
- Rollovers to individual annuity contracts, which includes services such as Income Solutions.

Note that a retirement income menu could offer an "outside the plan" option, and if an employee elected such an option, the plan administrator would facilitate the rollover.

Considerations for deciding whether to include the options inside or outside the plan include:

- For managed payouts, can the plan administrator deliver the periodic payments to plan participants according to their elections and keep track of assets for compliance reporting purposes? Many plan administrators lack this capability. In this case, the plan sponsor could implement an election by a plan participant for a managed payout fund by facilitating an IRA rollover outside the plan to a managed payout product offered by a mutual fund company or financial institution.
- Annuity products offered inside the plan must be offered on a unisex basis. Annuities purchased outside the plan can be priced on a sex-distinct basis. Since women are expected to live longer than men, unisex pricing favors women while sex-distinct pricing favors men. However, there's a possibility that group pricing of unisex annuities within the plan can offer men a better deal than sex-distinct pricing of individual products, due to reduced administrative costs and commissions that reflect institutional pricing.

From the participants' perspective, many of the above nuances don't matter. All that matters to them is that they see a menu of income options, that the employer provides a robust communications program, and that the plan administrator carries out their elections. If the employee elects a managed payout, they may not care whether their assets stay in the employer's plan or are rolled over to an IRA.

Plan sponsors will then need to carefully consider whether to offer choices inside the plan, outside the plan, or some combination that works best for all parties. In any case, a plan sponsor needs to carefully design and implement the retirement income menu, as discussed next.

Fiduciary Considerations

Many plan sponsors are concerned that they might incur additional fiduciary liability if they offer a retirement income menu, and they're waiting for regulatory guidance on this issue. However, ERISA already provides guidance through its fiduciary standards, including the "prudent man" rule, which I'll summarize below. Plan sponsors already operate in accordance with these standards in operating their defined benefit and defined contribution plans, including designing and managing the investment menu in a DC plan. While the retirement income menu has details that are new, the overall prudent process that a plan sponsor should follow is the same.

The ERISA standard requires that fiduciaries engage in a prudent process to make decisions, and that they discharge their duties solely in the interests of plan participants. Fiduciaries must act carefully, skillfully, and diligently in a way that a knowledgeable person would act in a similar situation. The focus of this standard is on conduct rather than results – what process did the fiduciary follow in making decisions?

In particular, the Department of Labor has described a number of steps in this prudent process:

1. Fiduciaries must determine what information they should know that is relevant to the decision.
2. They must gather the information needed to make the decision.
3. They must evaluate the information.
4. They must make a decision based on the information that's been gathered and analyzed.

The above process should be documented in writing.

What are the features that should be analyzed? Here's a potential list:

- How much retirement income can be delivered by a specific option, given a consistent set of circumstances regarding a plan participant?
- Is there a guarantee of payments for the lifetime of the plan participant?
- Under what circumstances can the retirement income be reduced or increased?
- What are the costs and fees?
- What has been the investment performance of the underlying investments?
- Can principal be accessed?
- What is the financial strength of the institution offering the product? With respect to annuities, the Department of Labor issued final regulations on October 7, 2008, that provided guidelines and a safe harbor for selecting annuity providers for individual account plans; these guidelines included reviewing the ability of the institution to meet future payment obligations.
- What are the administrative considerations?
- Can an election be changed by the participant after the income has started, and if yes, are there any penalties?
- What communications and education are offered by the financial institution to help participants understand the option?
- What are the issues with changing or removing a particular method from the menu, in particular if an insurance company, mutual fund company, or other financial institution delivers a specific retirement income option.

A special consideration is the default option that comes into play if a retiring employee doesn't make a decision, which is discussed in the next section.

Plan sponsors should work with their benefits counsel to obtain a level of comfort with the process when designing a retirement income menu.

Default Option

When considering whether to offer a retirement income menu, many plan sponsors that I've met express concern about the lack of regulatory guidance that protects them from participant losses. Specifically, they would like guidance on a default option that would apply to an employee who terminates employment without making an election in the retirement income menu.

In the U.S., a reasonable default retirement income option that a plan could adopt would be to combine:

- A fund that satisfies the Department of Labor's requirements for a Qualified Default Investment Alternative (QDIA), with
- The Required Minimum Distribution (RMD) under the Internal Revenue Code.

The RMD delays payments until the participant has reached age 70-1/2; thereafter, payments are made over the participant's expected lifetime (or joint lifetimes, if the participant is married). In most cases, the initial withdrawal is 3.6% of the account balance; this percentage increases each year thereafter. With the RMD, an annuity isn't purchased, and there's no guarantee of lifetime retirement income.

The RMD has the following advantages as a default option:

- It's not permanent; at any time, an employee can make an election with respect to the remaining account balance. This feature is generally not available with annuities.
- Delaying payouts until age 70-1/2 and then spreading payouts over a participant's expected lifetime helps address the challenge of outliving financial resources.
- It's difficult to imagine the employer incurring a successful legal challenge from an employee with a default option that's called the "Required Minimum Distribution" by the IRS. In fact, if an employer didn't require the RMD to apply at age

70-1/2, the IRS would apply substantial penalties to the employee, and an employer would be open to liability if it *didn't* use the RMD. As a result, many plan sponsors use the RMD if an employee hasn't made an election, so in effect, these plan sponsors already use the RMD as a default payout option.

You might make an argument that the above-described default may not be considered the "best" choice for employees. But that's not the goal of this default. Until regulatory guidance on default payouts is provided, the primary purpose of the default option is to protect the plan sponsor from liability, and that's the goal of the above default.

Other countries may have their own regulatory requirements regarding default payout options. Plan sponsors in the countries that don't have regulatory guidelines could consider adopting features and principles of the QDIA and RMD that exist in the U.S.

Example of a Retirement Income Menu

Now that I've described the most important issues regarding a retirement income menu, let's look at one example of a menu that offers six choices (all but the installment method and the RMD default are "outside the plan"):

- An immediate annuity would be purchased using an immediate annuity purchase platform. Such an annuity could be fixed or inflation-adjusted.
- An immediate variable annuity would be purchased that is adjusted according to an underlying portfolio of stocks and bonds.
- Participants could direct that their account be rolled over to a mutual fund's managed payout fund, where the underlying investments are allocated between stocks and bonds. Payouts are intended, but not guaranteed, to be made over a 25-year retirement.
- Participants could elect an installment method, specifying a fixed dollar amount or fixed percentage of the account balance that is paid each quarter (an "inside the plan" option).
- The IRS required minimum distribution (RMD), starting at age 70-1/2, coupled with a target retirement date fund that is appropriate for a retiree aged 70. This is the default option, and is also "inside the plan."
- A lump sum rollover as directed by the participant.

Participants could allocate their account balances among one or more of the above options.

Summary

The retirement income menu is an idea whose time has come:

- There is sufficient fiduciary guidance to employers on how to design and implement such a menu while minimizing their exposure.
- Many products and services have been introduced lately that are intended to generate lifetime retirement income, while other products, such as immediate fixed annuities, have been available for years.
- There's robust academic literature that analyzes how various methods to generate lifetime income meet different financial goals. It's not a mystery how to generate lifetime retirement income.

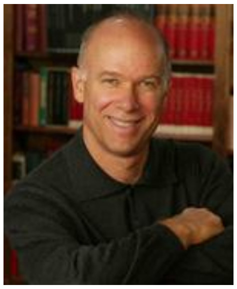
There are no remaining barriers to implementing the retirement income menu today. It's likely that there will be future regulatory guidance, new products and services and additional insights that might require future changes to your retirement income menu, but we don't need to wait for these developments to proceed with implementing a retirement income menu today. And after all, this is the same as the current situation with the investment menu in DC plans. The cost of waiting for the "perfect," government-stamped solution is likely greater than the cost of prudently proceeding today with available products and services.

The retirement income menu meets a significant challenge faced by employers and employees alike -- helping employees decide how to deploy their retirement savings to generate lifetime retirement income. In turn, this helps employees make informed decisions on when they can afford to retire.

Why should an employer go through the trouble to implement this menu? There are several, critical reasons. It helps employers manage an aging workforce, improving morale and productivity among older workers. It helps our society deal with an aging population. It helps you become an employer of choice. And it's simply the right thing to do for your employees.

The next step? Please take the time to discuss this timely idea with your benefits counsel and/or your retirement plan consultant.

About The Author



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Steve's retirement creations include:

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- The book, *Recession-Proof Your Retirement Years: Simple Retirement Planning Strategies That Work Through Thick or Thin*
- The DVD/workbook package, *The Quest: For Long Life, Health and Prosperity*
- The book, *Live Long & Prosper! Invest in Your Happiness, Health and Wealth for Retirement and Beyond*
- The book, *Don't Work Forever! Simple Steps Baby Boomers Must Take To Ever Retire*

He is an experienced speaker, with over 300 presentations, keynote addresses and workshops on his published works. Steve graduated Summa Cum Laude from the University of California, Irvine with a double major in Mathematics and Social Science, and is a member of Phi Beta Kappa. Steve is a Fellow in the Society of Actuaries and a Member of the American Academy of Actuaries.