Effective Due Diligence for Guaranteed Lifetime Income Options

With ongoing market volatility and a continuing transition away from traditional pension plans, a new type of investment and savings vehicle is attracting a significant level of attention in retirement planning circles. Guaranteed lifetime income options, or GLIOs, have caught the attention of many – including insurers, financial services firms, plan sponsors and regulators – as a means to help retiring workers protect their incomes over a longer retirement time horizon.

Sometimes called total income replacement solutions or personal pension plans, GLIOs look like an attractive choice for those who experienced sudden drops in the value of “target date” funds during the last few years. However, GLIOs are not a good fit for everyone, and therefore, plan sponsors must assess this new type of investment vehicle in light of their fiduciary duties, the likelihood of evolving regulations and potential future market impacts.

This article highlights some of the critical issues and questions that companies must consider as they evaluate GLIOs for their own retirement plans and conduct due diligence about specific products. Our viewpoint reflects conversations we have had with large insurers on their offerings to their own client base and plan sponsors as they explore whether these benefits should be included in their retirement plans.

Defining our terms

GLIOs refer to a specific type of investment vehicle designed to produce a steady annual income for retirees, replacing their compensation from their working years. Variations of these have been available through retail channels for a number of years, but have only recently entered the retirement plan market. Common features of GLIOs include:

- Guaranteed minimum income for life available either through regular payments or “on-demand”
- Potential increase in payment amounts based on market growth
- Income levels protected in the event of market downturns
- Flexibility to stop payments, transfer money to other plan options or, if value remains, to other beneficiaries upon death

While there are some similarities to traditional payout annuities, GLIOs are generally more flexible and provide added protection in the accumulation phase. GLIOs also function differently than daily-valued mutual funds, and the guaranteed values are not necessarily liquid in the traditional sense. Because of their guaranteed nature and higher level of administrative complexities, GLIOs typically have a higher total cost than a daily-valued mutual fund and/or produce a lower level of income than a traditional payout annuity for the participants.

Higher fees and more complex administrative considerations mean increased due diligence by the plan sponsor prior to selection and implementation. Further, the methods and models used to evaluate and monitor investment options traditionally offered in a participant-directed retirement plan need to be revisited to analyze the unique features of GLIOs. Because they are new to the market, different industry stakeholders call GLIOs by different names. The most popular are:

- Guaranteed retirement income solutions
- Guaranteed lifetime withdrawal solutions
- Personal pension plans
- Personal defined benefit plans
- Insured defined contribution plans

The descriptions of these vehicles may be slightly different, but they mostly mean the same thing – investments designed largely to protect and guarantee retirement incomes for individuals.

Why GLIOs? Why now?
The main appeal of GLIOs over traditional investment options is their unique ability to help individuals protect a large part of their retirement incomes by safeguarding them against the effects of market turbulence and longevity, while, in some cases, still offering growth potential during bull markets. They are also relatively simple from an asset allocation perspective and can offer the participant greater control than annuities.

GLIOs can also help alleviate the stress and uncertainty retirees face as they assume responsibility for their own financial planning – and especially the big decision of how to invest the one-time lump-sum payment of accumulated benefits. It is no surprise that many industry stakeholders view GLIOs as a natural bridge from retirement plans focused on defined benefits to those centered on self-direction and defined contributions.

The rising popularity of GLIOs appears to be largely a result of the 2008-09 financial crisis, which saw a severe decrease in the value of so-called "target date" funds. Many individual retirees who were counting on such funds for their impending retirements saw their balances suddenly drop by 20% to 30% or more. Many plan sponsors offering these time-sensitive funds decided to reassess the role of such vehicles in their retirement plan investment structures. Since target date funds could not protect future retirees from such painful market downturns, plan fiduciaries began to question if another approach may be more successful.

Companies may adopt GLIOs for other reasons. They may be viewed as recruitment and retention tools for companies seeking to attract a high performing workforce. There are also cultural considerations. Organizations with a paternalistic attitude towards their workforce may wish to offer extra protection and guidance for retirees as part of their retirement plan, especially for those participants who are losing traditional pensions or defined benefit plans.

In the post-crisis fallout, regulators, including the US Department of Labor, began to examine the issue of retirement income protection. Hearings have been held regarding time-specific funds and the emerging class of guaranteed income replacement vehicles. The U.S. is not alone; a number of other countries continue to closely study the use of retirement vehicles similar to GLIOs for federally administered programs. The UK, Australia and Canada are among those nations with regulations around retirement plan structures, allowing personal pension plans for small companies and individual workers.

Asking the right questions
While GLIOs are gaining momentum in certain segments of the market and more benefits professionals are becoming aware of them, adoption remains relatively low today. Moving forward, however, there are many signs that adoption will increase as GLIOs offer undeniable appeal for employers looking to strike a balance between the cost and security of defined benefit plans and the higher risk of self-directed plans.

For such companies, the central issues then become:

- Are GLIOs right for some or all of our workforce? If so, which type of solution is right for us, and is only one provider enough?
- What is the impact on plan design and administration?
- Given our objective, what is the best way to offer a solution like this to encourage appropriate utilization?

Collectively, the answers to these questions add up to a strategy and process for effective due diligence for meeting fiduciary obligations to employers, workers and retirees.

Taking a closer look at GLIOs
To determine if adding GLIOs should be a priority, plan sponsors should consider a few basic qualitative issues, such as workforce risk profile and sophistication, participants' current investments, current saving levels, appetite for portability and the overall need for long-term income replacement. Generally speaking, GLIOs are a better fit for companies with income replacement needs beyond Social Security and/or remaining defined benefit plans.

Even for companies meeting this high-level criteria, it may be risky to offer these options without considering how much education is necessary for the workforce and retiree population. Inclusion of GLIOs may lead some employees to “accidentally” pick the option based on the attractive-sounding name without considering the potentially higher fees and/or actual income replacement needs. As such, the financial IQ of employees (including their ability to understand the benefit, compare it to other options and match it to their unique needs) should be factored into initial and ongoing participant education.

Another important consideration is the employer/employee relationship. To some extent, that is a question of company culture. Is the employer/employee relationship protective, with strong advice and guidance offered (either directly or through third-party advisors)? Or is the emphasis on “do-it-yourself” planning? These types of cultural questions are often afterthoughts when fund and investment choices are made, but they are important factors in the evaluation of GLIOs.

A plan sponsor will also want to consult with its plan provider or administrator to determine if adding a GLIO will subject their plan to additional rules. For example, there was a recent Private Letter Ruling (PLR 201048044) issued by the IRS that implies that guaranteed withdrawals under some GLIOs constitute a “life annuity” for purposes of the qualified joint and survivor rules, which may require additional compliance considerations such as obtaining spousal consent for certain distribution options.

The following scenarios reflect some of the baseline considerations for workforce demographics where companies might be deciding if they should offer GLIOs:

Large manufacturing company with low average salary: This company has 1,000 union employees with an average annual salary of approximately $20,000. Most of these employees have a modest defined benefit plan and individual 401(k) balances represent their only savings. The combination of Social Security and pension benefits will replace most of their salary in retirement. As such, GLIOs are not likely to be a good fit for such an employee population. However, to ensure fiduciary responsibilities are met, plan sponsors and benefits administrators should study the options carefully and formally capture their reasons for not offering GLIOs at the time of the evaluation. As these products continue to evolve, they should re-evaluate this decision periodically within the context of their overall retirement plan.

Mid-sized consultancy with higher average salary: Compare the manufacturing firm to a mid-sized consultancy with 500 employees and an average annual salary of $50,000. Most likely, this educated workforce would have the savvy to understand how GLIOs work and to make an assessment of their own needs. They likely have substantial savings in their 401(k) plans and perhaps some outside assets. Furthermore, this group is more likely to need income replacement beyond Social Security. In some cases, the gap could be in excess of 50%. These factors are positive indicators that GLIOs could be a good fit for this firm — a valuable option in their portfolio for senior or high-earning employees, but not necessarily something for every employee. Here again, documentation of the due diligence process is important, as well as the rationalization for the plan design and demands for employee education.

Small law firm with very high average salary: This law firm has 250 employees with an annual average salary of $250,000. In general, the group has a high degree of financial literacy. While GLIOs may be appealing, especially for partners and senior attorneys, an in-plan option may not be in the best interests of the workforce’s retirement plans or of the employer. The retail products available in today’s market provide a higher guaranteed minimum income than the currently available institutional products. Many of the attorneys will already have an existing relationship with an investment advisor. In addition, it would be reasonable to expect this group to have the majority of their personal savings outside of the retirement plan. As such, it may be better to loosen the in-service distribution provisions and educate participants on GLIOs available in the retail market as an out-of-plan benefit.

Seeking the right partners, providers and plan design
In situations where offering a GLIO makes sense, plan sponsors should address choosing the right partner, optimizing the plan design to accommodate the GLIO and easing the selection decision for plan participants through effective communication and education.

A first step is to understand if GLIOs will be a primary or secondary consideration. Companies can justify including GLIOs as a plan benefit if they expect them to be important to a subset of their employees. On the other hand, if interest or need is expected to be relatively limited, then companies may choose not to offer an in-plan GLIO. There may also be cases where the plan sponsor may wish to adjust other plan provisions to enable employees to select “out-of-plan” GLIOs with the help of their personal advisors (as in the aforementioned law firm example).

The RFP process will be important to uncover any peculiarities in the current market offerings. For instance, particular GLIOs may not be supported on all recordkeeping platforms. Whether or not the benefit is portable between recordkeepers upon termination (either by the employee or plan sponsor) is another issue to assess. If plan sponsors decide to change providers and there are “in-the-money” benefits, the risk of fiduciary conflicts must be addressed. These details are important in designing the plan and evaluating partners and providers.

Given the complexity of the **quantitative** analysis, organizations and their benefits professionals will likely want to thoroughly examine the **qualitative** issues to narrow the number of solutions in which to conduct a thorough risk-value analysis. Providers should then be assessed in terms of the cost, benefits and complexity of their offerings. Even though the plan sponsor is making a decision for the entire group or class of employees, it often makes more sense to look at potential results at the participant level.
One approach to this evaluation is to use several representative profiles to evaluate the risk/reward profile of each GLIO that is being considered.

In the following section, we walk through a risk/reward profile for a 55-year old woman who works at a mid-sized consultancy firm. We have made the following assumptions about our representative profile:

- Current salary is $50,000
- Current savings in the retirement plan is $150,000
- Total annual contribution from all sources is $10,000
- She retires at her Normal Retirement Age (NRA), which is 67
- She invests in a target date fund with a glidepath that results in 25% equity 15 years after retirement

We considered three different options to generate income in retirement. Option 1, the default option, was a 4% inflation adjusted systematic withdrawal plan (SWP). In the SWP, the first withdrawal she takes upon retirement is 4% of her accumulated retirement plan balance. Each year thereafter, she increases the withdrawal amount by inflation.

Option 2 was an in-plan guaranteed lifetime withdrawal benefit (GLWB), which is a type of GLIO that is currently available in the market. The GLWB guarantees that she can withdraw 5% of the protected amount, which is the highest account value on any of her birthdays or the account value when she begins taking withdrawals, whichever is greater. As long as she doesn’t take more than this amount, her income will never decrease, even if her account value is exhausted. If her investments perform well in retirement, she has the potential to increase her guaranteed income.

Option 3 was a fixed deferred immediate annuity (FDIA). Each contribution into this benefit purchases a specific amount of guaranteed income to begin when she retires. Until she retires, these funds are accumulated at a guaranteed interest rate and can be changed to another investment in the plan using a commuted value calculation. However, once she retires, the funds are converted into income and she will lose access to the funds.

When conducting a **quantitative** review, the plan sponsor will want to identify the key questions to use to assess the risk-value analysis. For this particular example, we considered the following four objectives to be the relevant questions to address as part of the quantitative review:

1. What is the real replacement ratio at various points in retirement?
2. Which option provides the most real income?
3. How much money is available in the event of an emergency?
4. How much longevity protection does each distribution approach offer?

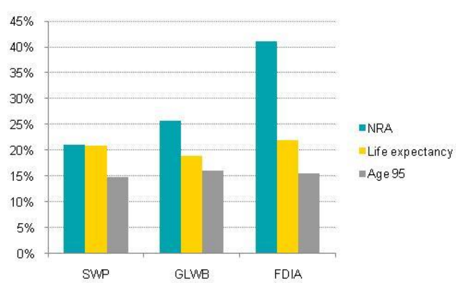
We ran Monte Carlo simulations to compare the three options to generate income in retirement. It will be important to tailor the analysis to the criteria that were identified to be most important considerations in the qualitative assessment.

Objective 1: What is the real replacement ratio at various points in retirement?

Exhibit I shows the average inflation adjusted replacement ratio under each distribution approach at various future ages (NRA, life expectancy and age 95). A higher bar indicates a larger replacement ratio. As expected, both GLIOs generate higher real income when income begins. While the FDIA has the highest initial income, it remains fixed and is gradually eroded by inflation. By age 95, the average inflation adjusted replacement ratio is approximately equal between distribution approaches.

Exhibit I: Average inflation adjusted replacement ratios (indexed to NRA)

	Distribution approach		
Measurement age	SWP	GLWB	FDIA
NRA	21%	26%	41%
Life expectancy	21%	19%	22%
Age 95	15%	16%	16%

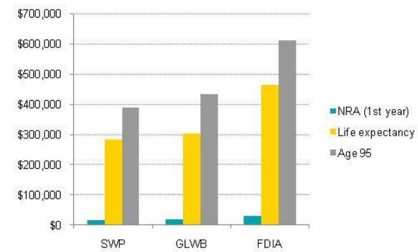


Objective 2: Which option provides the most real income?

Exhibit II shows the average sum of real income generated by each distribution approach through various future ages (NRA, life expectancy and age 95). A higher bar indicates more real income. At NRA, the SWP produces an average real income of approximately $16,000. At all measurement ages, the FDIA produces much more income on average than either the SWP or the GLWB distribution approaches.

Exhibit II: Sum of real income

	Distribution approach		
Measurement Age	SWP	GLWB	FDIA
NRA (1st year)	$15,705	$19,229	$30,688
Life expectancy	$282,263	$302,646	$465,348
Age 95	$390,145	$434,018	$611,529

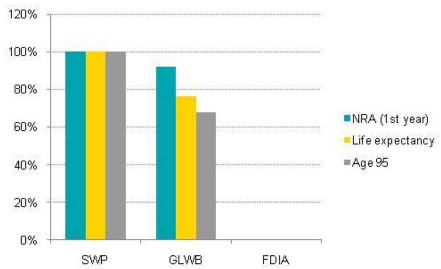


Objective 3: How much money is available in the event of an emergency?

Exhibit III shows the ratio of the account value under each distribution approach to the account value of the SWP at various future ages (NRA, life expectancy and age 95). A higher bar indicates more access to funds. Once income begins, the FDIA does not have any liquidation value (i.e., payments cannot be stopped/traded for a lump-sum withdrawal). This limitation is the tradeoff for a much higher income during life. The GLWB provides access to the account value at any time equal to the remaining account value. However, if a participant takes more money than the guaranteed income amount in a year, the guaranteed income amount in future years will decrease. In addition, the GLWB has higher fees than the SWP, the cumulative effect of which is the reason that the ratio of account value under the GLWB to the SWP is less than 100% and declines over time.

Exhibit III: Ratio of GLIO to SWP account value available for withdrawal

	Distribution approach		
Measurement age	SWP	GLWB	FDIA
NRA (1st year)	100%	92%	0%
Life expectancy	100%	76%	0%
Age 95	100%	68%	0%

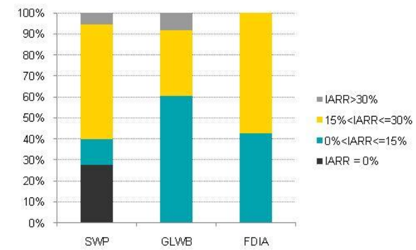


Objective 4: How much longevity protection does each distribution approach offer?

Exhibit IV shows the distribution of inflation adjusted replacement ratios (indexed to NRA) at age 95 by distribution approach. Each bar represents 100% of the scenarios that were tested. On this chart, black represents the probability of exhausting all funds and having no income. This situation occurs in 28% of the scenarios for the SWP. Both of the GLIOs (the GLWB and the FDIA) guarantee income as long as the participant is alive; therefore, income will not cease. However, real income will be eroded by inflation over time. The FDIA begins with an inflation adjusted replacement ratio in excess of 40% and has declined to less than 15% in 43% of the scenarios. The equity exposure present in the SWP and GLWB distribution approaches provides more protection to maintain the purchasing power of income. It may make sense to view this type of chart at other ages to see the distribution of potential outcomes at other important ages.

Exhibit IV: Distribution of Inflation Adjusted Replacement Ratio (IARR) at age 95

	Distribution Approach		
IARR Band	SWP	GLWB	FDIA
IARR = 0%	28%	0%	0%
0%<IARR<=15%	12%	60%	43%
15%<IARR<=30%	55%	31%	57%
IARR>30%	6%	8%	0%



Conclusion: To utilize this type of framework, the plan sponsor and its advisor should evaluate the relative importance of each selected objective and then choose the option or options that make the most sense for the plan.

Looking ahead: GLIOs in context

While it is premature to say that GLIOs will become staples of retirement plan design in the near future, there can be little doubt that they will become more familiar features on the landscape. That is largely true given their ability to replace traditional pension plans by protecting workers against market volatility and the risk of outliving their assets.

Plan sponsors should begin to engage in discussions with their investment committee on how to modify their due diligence process to determine whether a GLIO is appropriate for their plan and, if so, how to select the right GLIO for their workers. Organizations must ensure that GLIOs are consistent with their investment policy statements and benefits philosophy, in addition to following a diligent selection process. Further, they should make sure that potential partners can work within the existing plan infrastructure.

It is important to note that the goal of initial discussions and analysis is not to decide whether GLIOs are in the best interest of specific participants, but rather to make a qualitative determination of whether to offer the feature and how important it is in the provider selection process. Once this very basic determination is made, a thoughtful and meaningful provider selection process can be pursued.

Today, making such a determination requires careful and thoughtful answers to the broad set of questions outlined above.

About the Authors

Ben Yahr is an executive in the Insurance and Actuarial Advisory Services practice of Ernst & Young's Financial Services Office and is based in Philadelphia. Ben can be reached at (215) 841-0577.

Jennifer Haid is an executive in the Insurance and Actuarial Advisory Services practice of Ernst & Young's Financial Services Office and is based in New York City. Jennifer can be reached at (212) 773 4624.

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