Article brief – An interview with Kevin Hanney – Senior Director, Pension Investments at United Technologies Corporation (UTC) and the Institutional Retirement Income Council (IRIC)

Background:

In years leading up to 2012, UTC launched a review of the retirement benefits offered to U.S.-based employees, including an examination of the role their 401(k) plan might play in supporting the financial goals and objectives of their employees in the future. UTC also wanted to reaffirm that the benefit design of the plan complemented and supported its corporate goals. Specifically, UTC wanted to ensure that the 401(k) plan:

- effectively assisted in attracting and managing their most precious resources -- employees;
- offered access to high quality and low cost options to save and invest for the future;
- provided opportunities to establish and build secure retirement income while working;
- delivered the confidence and capacity for employees to retire on their own terms.

The review led UTC to partner with service providers in the defined contribution industry to design a retirement income solution for participants enrolled in the company's 401(k) plan and embed it within the investment glide path of its target date funds. UTC rebranded the combined strategy and adopted it as the qualified default investment alternative (QDIA) for new hires enrolled in their plan since its launch on June 1, 2012. Known as the *Lifetime Income Strategy*, UTC's default option provides:

- guaranteed lifetime retirement income backed by three insurance companies;
- income "step-ups" and account growth in response to contributions and investment gains;
- daily account liquidity, free of surrender charges at all times – even after payouts begin.

The Lifetime Income Strategy employs three identical, institutionally-priced and competitively bid variable annuity contracts that offer guaranteed lifetime withdrawal benefits (GLWBs) designed to protect retirement income from:

- market declines;
- longevity risk; and
- sequence of return risk.

In essence, UTC's Lifetime Income Strategy replicates some of the most effective features of a defined benefit plan within its 401(k), while preserving the freedom and flexibility that participants and plan sponsors have come to expect from today's defined contribution plans.

This past June marked the fifth anniversary of UTC's Lifetime Income Strategy. IRIC recently met with Kevin Hanney, UTC's Senior Director of Pension Investments, who has responsibility for oversight of the company's 401(k) plan, to discuss his experience with offering lifetime income and the future of retirement income for defined contribution plans.

IRIC: So, let's get right to the issue Kevin: any major surprises in offering the Lifetime Income Strategy to your employees?

Kevin: Nope. No major surprises. The Lifetime Income Strategy has performed as we expected. Specifically, our new employees generally accept it as the plan's default and thousands of our existing employees have actively allocated a substantial amount of their retirement savings to the option. That might sound surprising for something that hadn't been done before on this scale, but people should know that we took our time designing it. Our development process was years in the making and we incorporated input from a wide range of experts both from within the organization and people on the outside. Extensive preparation and those broad perspectives are what made it an "overnight" success.

IRIC: Would you have done anything differently if you had the chance to turn back time to 2011 and 2012?

Kevin: Yes, but I lost those debates before 2011 and can't go back now. [Laughs]

Seriously, though, we never stopped learning and there will always be things we can do to enhance our innovations. Regarding the design of the Lifetime Income Strategy, we generally got that right. But we were very conservative in our approach to communicating with employees and explaining the details of the offering at first. Over time, we are learning how important it is to focus communications and educational material on the end value of the offering. We still have materials that cover all the technical nuances, and we could probably teach college-level classes on all of the design and risk mitigation features of the Lifetime Income Strategy. But our employees don't need to know how to build it. That's my job.

What our employees really need to know is how to use it and what's in it for them. So, we are focusing more on user experience going forward and showing people how simple and effective it can be to meet their needs.

IRIC: How important was your partnership with Human Resources to making this decision? And to being able to successfully launch the Lifetime Income Strategy in your DC plan?

Kevin: In a word? Critical. The folks in human resources were vital to everything we did. After all, retirement benefit plans, at their core, are really tools to help manage our most precious resource – our people. We worked very closely with our HR Benefits group and focused on some basic questions: Why are we offering a retirement plan in the first place? How can we design the plan to meet the needs of our employees? How can a properly designed retirement plan support the success of our business?

This introspection reached a turning point in the development of the Lifetime Income Strategy when it led us to conclude that access to secure income in retirement was a key element of an effective plan design. UTC moved forward with the Lifetime Income Strategy believing that it would help our employees live with less financial stress while they are working and retire with greater confidence in their financial futures. Offering secure retirement income through our DC plan can facilitate the management of our human resources in much the same way that our traditional pension plan did before it was closed. However, the flexibility of a defined contribution plan provides so much more opportunity for participants to tailor their retirement benefits to fit their unique needs and circumstances that, in many ways, it's even better.

Most people want more control over their outcomes, but that can come in many forms. Whether it means: 1) saving more than our default deferral rates in the Lifetime Income Strategy while they are working so that they will have more secure income in retirement; 2) mixing it up by splitting savings between the Lifetime Income Strategy and our investment-only options; or 3) forgoing the Lifetime Income Strategy altogether to pursue a more traditional 401(k) experience. Our plan offers it all.

In order to deliver this in the end, our internal staff (HR, Finance and Legal) all needed to be on the same page with respect to benefit plan design so that the plan provides important and meaningful benefits to our workforce, while satisfying all of our fiduciary responsibilities and ultimately supporting the success of the business.

Our 401(k) plan is designed to be a pension for the 21st century, and we believe the value of lifetime income is so critical from the design perspective that it became clear it should be part of the QDIA. Consequently, we designed the Lifetime Income Strategy to fit the requirements of the regulations: Employees automatically enroll in the plan after they are hired and an ERISA 3(38) fiduciary investment manager builds an investment portfolio personalized for each one of them based on their age-- all by default. Over time, that manager shifts each employee's investment allocation along a custom glide path designed specifically for UTC employees. As each employee approaches retirement, their investments gradually shift into a portfolio of variable annuities. The variable annuities maintain their investment allocation in a 60/40 stock/bond portfolio while also guaranteeing retirement income benefits that ratchet up with future contributions and investment gains. Our former employees can then activate their retirement income benefits at any point after reaching age 60.

People always have the option to move their money out of the Lifetime Income Strategy if they decide to forfeit some or all of their guaranteed retirement income. They do this by taking early and/or excess withdrawals. This is the only time their guaranteed retirement income will decline. They can transfer to any of our other investment options or take it out of the plan altogether, and they are never charged surrender fees for doing so, even after they activate their guaranteed retirement income and start taking withdrawals out of the Lifetime Income Strategy.

IRIC: Let's talk about some of the goals UTC had for the Lifetime Income Strategy – and whether those goals have been met.

<u>Kevin</u>: Well, we have over 29,000 participants investing more than $1 billion in the Lifetime Income Strategy today. Of that amount, approximately $470 million is allocated to the variable annuities that offer secure income. With future contributions and investment earnings, the secure income portion will continue to go up. The Lifetime Income Strategy is on track to eventually represent the lion share of the assets in the DC plan. As our default, we are automatically securing the future retirement of our new employees. So, our goal of providing the opportunity to acquire and build secure retirement income is being realized and we're doing it for some of the lowest fees around.

It will take time to see how the Lifetime Income Strategy develops and supports our other goals, but you can be sure we will be watching the program closely and fine-tuning things along the way.

IRIC: What aspects of the Lifetime Income Strategy do participants appear to appreciate most? Does it change based on their age, income, or savings? Let's discuss a few of them such as: guaranteed income; retirement income protection during down markets and growth in up markets; mitigation of sequence of return and longevity risk; ability to maintain higher equity allocations in retirement?

Kevin: That question perfectly illustrates the issue I noted earlier about our initial communication materials. When we get down in the weeds, we don't speak to employees' needs as they understand them. Things like risk tolerance as a balance between capacity and aversion, sequence of return and longevity risks---those things might mean something to a professional, but normal human beings don't think like that.

There are certainly some participants who are financially savvy and some might understand the benefits and risk mitigation afforded through the Lifetime Income Strategy. But many employees don't even fully appreciate the value of a stable income until they are faced with retirement and the prospect of no longer having a steady paycheck coming in. And most participants don't have the financial expertise it takes to fully understand all the nuances of their benefits. People are, quite frankly, more focused on their near-term goals such as day-to-day spending, mortgage payments and maybe college for their kids. At least, I know I am. It takes a lot to get them focused on risks that seem to be far off in the future like retirement.

Under the hood, it can be tough to truly appreciate all of the features and benefits offered through the Lifetime Income Strategy, but participants certainly do not need to understand all of the painstaking detail to make an informed decision and use their benefits effectively.

Think about it the way you might approach the purchase of a motor vehicle. Most consumers today will buy a car and not even look under the hood. Very few people really understand how the engine, transmission, and other components of the vehicle work. However, everyone who buys a car makes a value judgement on its reliability, comfort, safety, power, fuel efficiency and ease of operation. The same should be true of a well-designed retirement vehicle.

Participants in the Lifetime Income Strategy might not be interested in understanding how the benefit base is set – but they value downside protection. They want income security, but also want easy access to their assets in case of an emergency. Most people I know are completely disinterested in probability distributions and expected returns, but I haven't met anyone who frowns when we tell them it's likely that their guaranteed income will increase in retirement. It is hard to convey a good understanding of what 'sequence of return mitigation' means or to convince someone that living longer than average could be a problem, but it is easy for a participant to appreciate that their income is guaranteed to last for life regardless of how long they live and regardless of the volatility and behavior of the stock market.

In short, participants want to know about the value of the benefits and what they can do with them. They can assess and use the features without needing to know how to build and maintain them. They leave that part up to the professionals.

IRIC: Got it! Have employees been able to effectively convert their 401(k) balances into income?

Kevin: Yes. About 10,000 UTC employees are in the secure income sub-fund that holds the variable annuities and that number is going up. Their balances are being converted virtually every day, whether they realize it or not. The challenge is to build awareness so that they understand how their financial security is growing and the additional flexibility it offers them as they plan for the future.

For example, UTC was recently contacted by one participant that was researching secure income options outside of the plan. They even shared some deferred annuity quotes that they found through a financial advisor. Now, this participant had money in the Lifetime Income Strategy and knew that it offered secure income, too. They even tried to compare it to their outside quotes. However, they seemed to be unaware that they had already built up a valuable income benefit in their own account and didn't use any of the tools we offer that show them, not only what they have today, but how it could grow in the future. So, here's someone who was obviously motivated, spent time looking around for alternatives, but they didn't necessarily understand what they found or how to make a valid comparison between all of their options. Most importantly, the participant didn't appreciate that the Lifetime Income Strategy offers a number of benefits, one of which is that you can change your mind and leave if something better comes along.

In the end, we spoke with that participant and made sure they had all of the information they needed, but that was a valuable learning experience for us. We'll use it to enhance our communications in the future. We believe the Lifetime Income Strategy is a *best in class* retirement benefit, one of the best in the market today. We know that participants in the Lifetime Income Strategy have access to several features -- freedom, flexibility, institutional pricing, purchases over time creating a dollar cost averaging benefit, access to their market value and institutional investments, etc. , -- they can't find anywhere else. Going forward, we need to make sure that they know it, too.

IRIC: IRIC concurs. The Lifetime Income Strategy has set itself apart as a benefit. UTC and its businesses are a harbinger for the future of DC plans and institutional income. What impact, if any, has the Lifetime Income Strategy had on UTC's ability to manage its workforce? Does it appear to help employees be more "retirement ready?"

<u>Kevin</u>: Absolutely. Retirement readiness for our "DC only" employees (new hires after 2009) is probably the highest it has ever been and it should increase over time. When we look at the power of combining the Lifetime Income Strategy with the automatic features built into our plan design (automatic enrollment, automatic escalation, automatic diversification of company matching contributions and additional automatic company contributions), we could see many employees replacing most or all of their working income at the point of retirement with a high probability of seeing it increase well into retirement. Even under stressed scenarios, our forecasts suggest a reasonable expectation that the Lifetime Income Strategy can provide as much income as traditional pension designs with far more flexibility leading up to and throughout retirement. A workforce that is this retirement ready creates valuable opportunities for the next generation of employees.

IRIC: OK, that was a good retrospect for the Lifetime Income Strategy and the last 5 years or so. Let's turn the page. What does the future hold? Are there any planned changes you can share with us?

<u>Kevin</u>: Yes. We are thinking about some subtle changes that will enhance the offering but nothing dramatic. Most are "under the hood." For example, we are studying some subtle changes in our glide path, and we are trying to think through how to personalize the experience that would enable participants to take better advantage of the flexibility of the product and customize their guaranteed income to their preferred retirement age. UTC is a company built on continuous improvement, and we are never satisfied with the status quo. It's just part of our culture to continue to innovate as we move forward.

IRIC: A survey of 150 large plan sponsors by the Corporate Insight Group in 2016 found that while 64% of plan sponsors state that it is a high priority to implement a retirement income solution, only 16% currently have one in place. Reasons cited for the gap between the high interest and adoption are:

1. **a lack of availability of sufficient one-size-fits-all solutions**
2. **solutions being too costly for participants**
3. **sponsors waiting on in-plan safe harbor before feeling comfortable to proceed, and**
4. **the solutions are too complicated to explain to participants**

How would you encourage your colleagues to think about these challenges?

Kevin: Any plan sponsor expecting to find a "one size fits all" solution for its workforce is going to be disappointed. That's not the way employee benefits work. However, there are certainly solutions that exist today where the majority of employees (and probably the vast majority for most employers) would greatly benefit from the adoption of a retirement income solution in their DC plan.

Regarding costs, employers frequently underestimate the institutional buying power they have and the efficiency of delivering retirement income through a DC plan. These are powerful levers that can and should be applied to reduce costs. Frankly, features embedded within income products do have a cost, and often explicit fees will be higher than the fees on traditional investment-only options in their DC plan. However, those fees pay for protection, guarantees and lifetime income benefits that traditional investments don't offer, and the cost for offering products with those benefits through a DC plan can be considerably lower than comparable retail products that their employees might buy after retirement.

For employers waiting on additional guidance from the DOL, we really must acknowledge that the DOL already issued safe harbor guidance regarding annuities in 2008 and issued their QDIA regulations in 2007. Additionally, several other pieces of guidance have been published since then[1], all of which are favorable to the adoption of retirement income solutions in DC plans. Although we would all like a straight forward safe harbor approach to be adopted by the DOL, we believe there is sufficient guidance already issued by the DOL that would enable employers to adopt a guaranteed solution for their plan with confidence -- if they follow the available guidance.

My thoughts on the complexity of certain products, I suspect, are aligned with the thoughts and concerns of the plan sponsors in this survey. Annuities and living benefits can be difficult to explain and difficult to understand. However, UTC and the industry are learning how to communicate the benefit of such products in an easy to understand fashion where participants understand the value – without needing to know all the nuances and inner workings of the product itself. We continue to make progress.

Ironically, the implementation of retirement income products as part of the default fund can ease the communication challenge because here we can emphasize the benefits and value without weighing people down with the details of the product. All of that information should be available, but the lesson here is to focus on retirement readiness, secure income, and flexibility instead of the inner workings of a product.

[1] See Prudential's Guaranteed Retirement Income Update: A Timeline of Regulatory Guidance – also available on IRIC's website under our reference library / industry research

Most participants want to know the value of the solution, without all the details and industry jargon that can make education more complicated than it needs to be.

My final thought here would be to encourage plan sponsors to avail themselves of an expert if they do not intimately understand retirement income products. Industry experts can be of great assistance in evaluating various products and the financial strength of an insurer (if the retirement income is a guaranteed product) in accordance with a sound fiduciary review process.

The bottom line is that if employers engage in a thoughtful risk/reward analysis of a retirement income product for their plan, most would find that the rewards for their employees would outweigh their costs. "Perfection" should never be the enemy of a significant improvement. Plan fiduciaries should study the issue. And the study for most employers will lead to the adoption of retirement income solution(s).

IRIC: What could the industry -- including IRIC -- do to overcome and resolve challenges related to retirement income in a defined contribution world?

Kevin: Well, most of the time the loudest voices are the ones that people hear the most. Unfortunately, the loudest voices I am hearing today are focused on what can't be done instead of what can be done and that only preserves the status quo. The industry needs to carry the flag and ring the bell for retirement income if we expect the system to move forward.

We have to remember that the industry is very good at creating tools that can assist plan sponsors in the decision-making process. Efforts in that regard should continue and expand. For example, IRIC had a great comparison tool that compared SPIAs to deferred annuities and to income products with living benefits such as GMWBs. These are very helpful for sponsors and their advisors. The industry should do more of that, not from a competitive perspective as much as identifying what various products have in common, how they are different and the various ways they can address specific needs in retirement.

Also, I relied heavily on academic and white papers that I found over the years. The industry could help plan sponsors by gathering this material into something like a library or a curated repository so plan sponsors and their advisors can easily find and apply it to their informed decisions. Publishing new material covering the fiduciary selection process and how it applies to guaranteed income could be a blessing to many plan sponsors who want to move forward, but need more support with their legal compliance.

Additionally, I have been to more than a few conferences where sessions are devoted to retirement income issues that have been well attended by me and my peers. These forums are very helpful to plan sponsors.

Finally, I think plan sponsors will continue to maintain a keen interest in retirement income, so advisors should make it an important part of their practice and become more familiar with retirement income products and familiar with the fiduciary process to adopt them in plans.

IRIC: Thanks for the time today Kevin. We appreciate the efforts UTC has made on the retirement income front. Your adoption of the Lifetime Income Strategy has helped foster institutional solutions in the DC system that we believe increase the overall retirement security of plan participants. Your efforts certainly extend beyond UTC and have helped the others in the market consider these types of solutions for their own plan.

Kevin: Thank you. My pleasure!