What is a Non-Guaranteed Retirement Income Payout?

BACKGROUND

Employer 401(k) and other defined contribution (DC) retirement plans can (though are not required to) offer participants payout options other than lump sums. Among the options are guaranteed retirement income products provided through an insurance company for which there are many types offered. This summary addresses non-guaranteed options which we will refer to as **Non-Guaranteed Retirement Income Payout (**NGRIPs). Under a NGRIP the retiree assumes the investment risk associated with their retirement account balance as well as the risk of living longer than their account balance will last (longevity risk). Though benefits are not guaranteed, many retirees may prefer a NGRIP over a guaranteed income option for reasons that include, but are not limited to, flexibility and lower costs. This paper does not intend to compare guaranteed and non-guaranteed options, but to describe some alternative NGRIPs. Guaranteed and non-guaranteed alternatives each have their pros and cons and having a retirement plan offer both can be attractive to many retirees. Strategies including both guaranteed and non-guaranteed payout options may be beneficial for retirees.

ELEMENTS OF NGRIPs

There is no unique NGRIP structure. Among the main elements of a NGRIPS are the following:

1. The underlying investment portfolio can utilize the same investment options available under the accumulation stage of the plan or the plan can make other investment options available. Typically, different options are offered with different investment risk profiles.
2. There needs to be a process to determine the ***initial payout*** as well as any ***periodic changes*** to that payout. (Discussed in detail below)
3. At death the remaining balance, if any, is payable to the retiree's designated beneficiary.
4. The retiree generally has access to the account balance at any time.[1]

[1] Occasionally a non-liquid asset is part of the portfolio

DETERMINING THE INITIAL PAYOUT AND PERIODIC CHANGES OF NGRIPs

The first step in this process is to determine an initial payout. As noted, there are many possible options in the determination. Here are some often used approaches.

1. Percentage/flat. A percentage of the account balance or a flat dollar amount is determined. The traditional 4% rule falls under this category where the initial payout starts at 4% of the account balance and then increases annually with inflation.
2. RMD. The account balance is divided by the Internal Revenue Code Required Minimum Distribution (RMD) Factor or some derivate of that factor.
3. Actuarial. An actuarial approach is used where the initial amount is determined based upon an assumed life expectancy and investment return. [2] [3]

After the initial year payout, it is common (though not required) for the payout amount to change. Subsequent year payouts are generally related to how the initial year payout was determined.

1. When a percentage of the account is used the amount could stay the same, or it could be recalculated to reflect investment experience.
2. Flat dollar payouts are generally continued at the same amount but could be revised if desired.
3. In the case of the RMD approach, the payout is often redetermined annually based on table factors at the new age and the updated account balance.
4. Under the actuarial approach it is common (though not necessary) to adjust the payout annually to reflect investment experience and a change in life expectancy.

A main feature of non-guaranteed approaches is the flexibility in the payouts. A retiree can generally change their payout amount periodically and take unscheduled payouts if desired.

INITIATING A NGRIP

An employer should start by discussing with the plan recordkeeper if there is a NGRIP they already support. If this is not the case another current provider (investment advisor) or an outside consultant can be retained to help in the adoption or creation of one. More than one NGRIP can be permitted, though this could make it more challenging for retirees if they can select from several. Once a NGRIP is selected the Plan will likely require an amendment. A process will need to be put in place with the service providers to process scheduled payments (usually monthly but could be quarterly or annually) and initiate periodic payout changes as specified under the NGRIP.

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[2] Amount can be determined that reflects an annual increase based upon assumed inflation

[3] This approach is currently used by some financial planners working with individuals. Providing such an option in a DC plan would require life expectancy and investment return assumptions. This could be provided by the plan or selected by the retiree with some general guidance.

PARTICIPANT/RETIREE EDUCATION

First and foremost is making certain that it is clear that the retiree is assuming the investment and longevity risk when opting for a NGRIP and that the account balance may go to $0 while the retiree is still alive. A simple description of how any NGRIP available actually operates should be provided along with information on how a retiree can modify payments.

FIDUCIARY LIABILITY

To minimize potential fiduciary liability with respect to an NGRIP, plan sponsors should ensure that participants are provided accurate and complete information about the NGRIP, including disclosures related to fees, payout assumptions, and risks (*e.g.*, investment and longevity). It is critical that there are no explicit or implicit representations that would lead the participants to believe that the payments are guaranteed. Under ERISA, fiduciaries are required to act in the best interest of plan participants. Whether plan assets are being invested in the accumulation stage or payout stage, the requirements are the same. NGRIPs are likely to have expenses borne by participants using this feature. These expenses include the cost of developing modeling tools, determining updated payout amounts, as well as processing periodic payments. To the extent that these additional costs are paid out of the plan, a fiduciary should ensure they are reasonable.

CONCLUSION

Offering in plan retirement income options that do not require the purchase of an insurance product may benefit some retirees. Reasons include

- allowing for a smoother transition from employment to retirement
- employer plans generally have access to lower fees than individuals,
- retirees have knowledge that their balances are still under the direction of a fiduciary,
- the concern of making a non-reversible decision is eliminated.

This is not to say that guaranteed income solutions are of any less value. For many retirees knowing that they can receive a guaranteed fixed income for life is very reassuring as opposed to a NGRIP where there is no guarantee of a fixed lifetime income payable for life. It actually turns out that a combination of a non-guaranteed and a guaranteed solution may be optimal for many retirees.