IRIC

INSTITUTIONAL RETIREMENT INCOME COUNCIL

In Plan Combination Retirement Income Solutions

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Introduction

Retirement income is not a one size fits all solution for each retiree. There are a variety of approaches that individuals can use to convert their nest egg into retirement income. Broadly speaking, there are two primary categories: guaranteed solutions and non-guaranteed solutions. Within these two, many options and combinations can be used to try to achieve a desired result.

Guaranteed solutions include an insurance component designed to provide lifetime payouts, but generally lack flexibility. Non-guaranteed solutions are investment-based and offer potentially greater income and flexibility, but with the risk that the income generated will be less than expected or be exhausted before the death of the retiree. Which solution (or combination of solutions) may be best for a retiree will depend upon many factors.[1]

Some defined contribution plans offer participants a retirement income option. Most of those that do only offer a non-guaranteed investment-based option, and there has been a general reluctance[1] in offering guaranteed solutions within plans. This reluctance is a result of a few reasons, including fiduciary liability concerns,[2] the fact that most plan advisors work in the investment space and are therefore less familiar with guaranteed solutions, and the lack of recordkeeping systems that support guaranteed solutions. The investment-based approach is not always in the best interest of all retirees as they must bear 100% of the investment and longevity risk.

Many retirees roll funds out of the plan into an Individual Retirement Account (IRA) which includes fees that are typically higher than those within employer plans and fiduciary protections may be weaker.[3] Further, retirees who are interested in a guaranteed solution may face “choice overload” outside of the plan, or be sold a product without fiduciary protections.

This paper addresses the potential value of offering a solution that combines guaranteed and traditional investments within a defined contribution retirement plan, which we will refer to as a “combination solution.” This combination solution is especially valuable for retirees lacking sufficient assets to safely provide a desired lifetime income level through an investment-based approach only. The concept of combining solutions was addressed in a 2007 paper, Lifetime Financial Advice: Human Capital, Asset Allocation, and Insurance (Chapters 4 & 5),[4] and has been explored many times since.

Below, we first outline some guaranteed insured solutions, and then show some examples of how they can be combined with investment-based solutions[5] to improve the likelihood of more favorable outcomes.

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1 Age, health, desire to leave a legacy, investment return and inflation expectations, and others

2 This has been partly mitigated by provisions of the SECURE Act.

3 Change likely with new fiduciary rule.

4 https://www.cfainstitute.org/-/media/documents/book/rf-publication/2007/rf-v2007-n1-4580-pdf.ashx

5 https://iricouncil.org/wp-content/uploads/2020/12/0810_Income-DConversation_1203VF.pdf for some examples of investment only based solutions

Type of Guaranteed Insured Products[6]

A. Single Premium Immediate Annuities (SPIAs): These are the most straightforward type of guaranteed solution. The insurer guarantees a monthly[7] pension for the life of the retiree and assumes the investment and longevity risk. The amount of the pension is based upon the individual's age at time of purchase and commencement, the amount of premium paid, actuarial assumptions set by the insurer, as well as the insurer's expenses. They can be sold with death benefit or cost of living increase options, but these will reduce the amount of the initial pension.

> *...retirees who are interested in a guaranteed solution may face "choice overload" outside of the plan, or be sold a product without fiduciary protections.*

B. Qualifying Longevity Annuity Contracts (QLACs): These are similar to SPIAs, but the benefit payment is deferred to an advanced age such as 85. A much higher monthly benefit can be achieved than with a SPIA due to the deferral period length and mortality risk of reaching the payout age. Like with SPIAs, QLACs can be sold with a death benefit, and other payment options are available. Note that the QLAC premium is exempt from required minimum distributions until income payments start.

C. Savings Annuity with a Guaranteed Lifetime Withdrawal Benefit (GLWB): Unlike SPIAs and QLACs, savings annuities (also known as deferred annuities) have an account balance. Savings annuities include variable annuities, fixed-rate annuities, and fixed index annuities, each with different risk/return aspects. The lifetime income guarantee is provided through a guaranteed lifetime withdrawal benefit (GLWB) feature, which provides a lifetime guaranteed payout amount based on a percentage of an underlying account value determined when payouts commence[8]. This feature can provide significant value if the account is depleted due to a long life or poor investment returns. GLWBs generally allow for unscheduled withdrawals, though this lowers the level of the guarantee.

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6 There are other insurance-based approaches that we do not cover in this brief, such as buying a series of deferred income annuities before retirement with the payments starting at retirement age.

7 The owner may choose to receive payments on a different cadence.

8 Alternative approaches to determining this guarantee exist based upon the product

Combining Guaranteed and Investment-Based Solutions

There are a variety of combinations that can be considered. Here are a few:

A. **Term Certain Investment Fund Payout with a QLAC:** The majority of the account is used to create a portfolio designed to generate an income that is expected to last up to a predetermined age such as 85. The remainder of the account is used to purchase a QLAC with payments starting at the predetermined age, and which addresses longevity risk.

B. **Balanced Portfolio with an SPIA:** Some portion (or all) of the fixed income allocation of the portfolio is held in a SPIA instead of a bond portfolio. The remainder of the portfolio is in equities. This approach may provide a higher return than traditional fixed income due to the impact of longevity credits[9]. A higher risk profile might be considered for the equity portion of the portfolio due to the guarantees of the SPIA in the fixed income portion.

Over the last several decades, the attention toward defined contribution plans has focused mostly on the accumulation stage. How retirees turn their nest eggs into reliable retirement income has typically taken a back seat.

C. **Balanced Portfolio with a Savings Annuity with a GLWB:** This is similar to the prior approach, except a savings annuity with a GLWB is used instead of a SPIA. There are trade offs to consider when choosing between a savings annuity with a GLWB over a SPIA. For example, with the GLWB approach, the account value of the savings annuity can be accessed at any time and upon the death of the retiree, any remaining account value can be bequeathed. However, in most cases, the SPIA will provide more guaranteed income.

D. **Payout Based Upon Required Income Level:** This approach uses either an SPIA or a GLWB-savings based solution in combination with Social Security and other guaranteed income (if applicable) to create a fixed income. This income level should be determined to cover the retirees' non-discretionary expenses. Funds not held in the SPIA or savings annuity-GLWB are held in an investment portfolio. Since an income floor has been guaranteed, depending on the retiree's risk appetite, the investment portfolio can be more equity-heavy with the potential for higher returns and/or greater inflation protection.

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9 https://www.financialplanningassociation.org/article/journal/NOV18-anuitized-income-and-optimal-equity-allocation

Challenges

Some of the roadblocks to having combination solutions within a plan are:

A. **Advisor Bias:** Plan advisors tend to be in the investment camp, and may not wish to consider insured options. This could be due to a lack of expertise, compensation model, or other factors. Plan sponsors should engage advisors who are knowledgeable about and willing to recommend varied solutions that can address plan participants' different situations.

B. **Employee Education:** With additional choice, plan participants will require a better understanding of the options available and the potential impact on the security of their retirement income or bequest motives. Modeling tools are very helpful to illustrate the differences between approaches under consideration.

C. **Recordkeeping Systems:** Changes need to be made to recordkeeping platforms to support guaranteed solutions and handle multiple options.

D. **Employer Reluctance:** Employers may not see the benefit of adding more complexity and potential liabilities to their offerings.[10]

Summary

Over the last several decades, the attention toward defined contribution plans has focused mostly on the accumulation stage. How retirees turn their nest eggs into reliable retirement income has typically taken a back seat. This has left millions of retirees vulnerable to the prospect of either running short of income in retirement, or being so fiscally conservative that they spend a lot less than they could have afforded and/or preferred. The combination approaches presented above can help mitigate longevity, investment, and inflation risks.

Advisors and recordkeepers should assess the benefits of supporting additional solutions that combine different approaches, and how by doing so, plan sponsors can increase the value of the benefits offered to their employees. By doing so within a plan, retirees would experience a more seamless financial transition to retirement, and benefit from the advantages of lower fees and financial expertise that may not otherwise be available.

10 Selection of guaranteed products should be based on a credit worthiness review of the insurer.

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