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A Workable Approach to Lifetime Income in Defined Contribution Plans

Interview with Kevin T. Hanney

Planning for retirement requires accumulating adequate funds to finance retirement and figuring out how to use those funds during retirement. Defined contribution plans are often used for retirement, but most of them do not include provisions to help employees receive benefits as lifetime income. United Technologies Corporation (UTC) has embedded a lifetime income approach in their retirement program and many employees and retirees are benefitting from it. Kevin Hanney, senior director, pension investments at UTC spoke about their defined contribution plan and its default option, the Lifetime Income Strategy, at the 2017 SOA Annual Meeting & Exhibit. *Retirement Section News* has asked him to share some thoughts with you.

Can you describe how employees buy and are paid lifetime income from your defined contribution plan?

Historically, UTC offered retirement benefits to our U.S.-based employees through a traditional defined benefit plan and a supplemental defined contribution plan. However, the defined benefit plan was closed to new entrants after 2009. Consequently, our defined contribution plan became the primary retirement benefit offered to new hires, and the Lifetime Income Strategy is now the qualified default investment alternative (QDIA) that we offer to those who are automatically enrolled in the plan.

(I should note that it's also available to everyone else in the plan . . . including me!)

The Lifetime Income Strategy is extremely simple to use once you are in it, regardless of whether you are automatically enrolled or you make a conscious decision to direct some or all of your savings into it. In fact, we intentionally designed it so the only decisions that people need to make are 1) when to "activate" their lifetime income, and 2) whether or not they will take a single or joint-life benefit if they are married. Everyone in the Lifetime Income Strategy is eligible to activate their lifetime income any time after they reach age 60 and leave employment with UTC, but it's their decision as to when they do so.

For most people, it makes sense to activate when they want to start drawing the guaranteed income from the plan that they acquired through the Lifetime Income Strategy. The activation process is so simple that all we require is a single, short form to be completed by each participant (and their spouse, if married). Everything else is done for them:

1. A professional investment advisor acting as an ERISA 3(38) fiduciary is responsible for managing a traditional, investment-only portfolio for each participant in the early years.
2. The same advisor is responsible for determining the timing and shape of the asset allocation glide path as they shift away from the pure investment strategy into a portfolio that holds variable annuity contracts backed by three very well-known and highly rated insurance companies.
3. The insurance companies guarantee that each person in the Lifetime Income Strategy may withdraw a minimum amount of annual retirement income from the balance in their variable annuities while the rest of their assets in the variable annuities remain invested in a diversified investment fund of passive investment strategies focused on long-term growth.
4. The insurance companies compete for allocations of new guarantees through a monthly competitive bidding process conducted by UTC with the assistance of our guarantee administrator.
5. Each dollar directed to the variable annuities by the investment advisor prior to activation increases the minimum amount of annual income that they guarantee.
6. Gains in the investment fund within the variable annuities will also increase the minimum amount of guaranteed annual income on each participant's birthday if the balance in the investment fund exceeds its previous highest birthday value. Investment losses in the funds do NOT reduce the guaranteed annual income amount.
7. The information included on the activation form confirms the age of the participant, and their spouse if they are married, and whether they are electing a single- or joint-life income benefit.
8. This information is used by our guarantee administrator to crystalize any applicable early or deferred retirement factors along with any adjustments that apply to joint-life benefits.

All of this is overseen by an ERISA 3(38) fiduciary, and is designed to manage the risks and complexity of accumulating retirement assets and converting them into a reliable source of secure and stable lifetime income.

A crucial aspect of the Lifetime Income Strategy is that people always have the freedom and flexibility to take their money out, even after they activate their guaranteed income benefits. It doesn't matter if they choose to do something else with their retirement savings because they think something better comes along, or if they are forced to take an unexpected withdrawal because a financial emergency comes up and this is the only way they can meet their urgent needs. They always retain the right to change their minds and they are not subject to back-end or surrender charges for any early or excess withdrawals.

Don't get me wrong. This might be a very expensive decision, because the combined value of the benefits available through the Lifetime Income Strategy can be quite substantial. So, we encourage people to explore all of their options before making that choice. However, sometimes it can make sense to forgo, or "forfeit," some or all of the guaranteed income, especially if there's a big change in personal circumstances. The bottom line is that they can simply pull out some or all of the balance in their investment fund at market value through an in-plan transfer or an outright withdrawal if their needs change.

At the SOA Annual Meeting, you mentioned that the SOA provided some ideas that helped you in designing the Lifetime Income Strategy. Can you elaborate on that?

We cast a very wide net looking for good ideas in the early stages of our development effort, and one of the logical places that we looked was within the actuarial community. I can remember trolling through the SOA website at all hours of the day and night, searching through presentations from past conferences and finding papers that inspired us to look beyond conventional approaches to retirement income. A lot of that influenced the ultimate design of the Lifetime Income Strategy.

However, the one of most innovative aspects of our design came from a concept published by a large and very well-known actuarial firm. It's called a "multiple lead carrier aggregation" platform. Ironically, we first heard about this approach through the investment advisor we work with today, and the idea became reality due in large part to our combined investment of time and resources. However, it all started with an actuary.

I understand that UTC buys the annuities from three financial service companies, and changes the mix monthly. Why three, and how is this working out?

Well, the "multiple lead carrier aggregation" platform concept is explicitly designed to facilitate working with more than one insurance carrier at a time as a source of insured retirement benefits. The form of benefits can change from one program to the next or even change over time within the same program. However, at its heart, it streamlines the recordkeeping and administration of the guarantees embedded in our variable annuity contracts and functions as a book of record for our service providers. It is also the mechanism that ties everything together operationally.

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It was important to UTC that our design incorporated a secure and reliable source of retirement income. There was always a sense that insurance of one form or another would be critical to provide the security and certainty that people need to retire on their own terms. We also have a long history of working with insurance companies through our stable value fund. Selecting annuity providers for the Lifetime Income Strategy was not as much of a stretch as you might think.

However, it was important to demonstrate to ourselves and anyone else that might ever ask about it that we went through a thorough and prudent process to select and monitor our service providers. So, we worked with our external partners to conduct an anonymous RFP and availed ourselves of as much information as we could gather; including financial strength ratings, credit analyses, statutory filings and just about anything else we could find. We also had extensive negotiations with all of our service providers, including the insurers that we ultimately selected to back the variable annuities and income guarantees.

It was an exhaustive process, but manageable and one where the value of choosing the right service providers clearly showed through.

Day to day, working with three insurance companies has been very successful. Each one has a unique view and we learn something every time we interact. It preserves a healthy degree of competition as well as sustainability in that we are not beholden to them and they are not bound to us. We can all grow and improve without stifling each other.

How many employees are currently buying future income and how many are receiving income from the Lifetime Income Strategy?

Well, you have to remember that we only launched in June of 2012 and most of our enrollment efforts have been focused on new employees so far. However, as of Jan. 31, 2018, over 30,000 people have invested more than $1.1 billion in the Lifetime Income Strategy. Out of that, over 12,500 people have more than $500 million allocated to the variable annuities backed by our three insurance carriers and those numbers are growing literally every day.

Only a very small percentage of people in the Lifetime Income Strategy have reached retirement age, separated from service at UTC and activated their income benefits. That's an area we are focused on today and we are expecting to see a very positive impact as more and more people reach this milestone. I hope to join them one day myself.

What have you heard from employees and retirees about the Lifetime Income Strategy?

People have told me they really appreciate the security and peace of mind they get from the Lifetime Income Strategy. I think it comes down to knowing their money will keep working for them after they retire and they don't have to worry that their income might decline due to investment losses. Perhaps even more importantly, they don't have to worry that it might run out due to extreme market events or longevity.

What have you heard from management?

I'm pretty sure that I'm part of management, so everything has been great (laughs).

Well, if what you mean is "What have we heard from the top of our organization?" then I can only say that we are very fortunate to have leadership that truly understands pension management and the financial impact it can have on an organization in today's environment. This project was already underway years before anything was ever discussed in relation to closing the defined benefit plan and staff was ready when we got the nod to say the defined contribution plan was moving to primetime.

That being said, UTC is built on a culture of continuous improvement. It's not in our nature to be satisfied with the status quo. I'm not sure that we will ever stop moving forward.

What would you say to an employee benefit manager who says "I would like to offer an income option in my plan, but I think it will be too complicated to manage"? Would you encourage her to use an income option?

I think income-based solutions are an excellent option for most plans as long as the plan sponsor has access to qualified, professional management, either through internal or external resources. I'm seeing a lot of development in the latter and it won't surprise me if you see more external service providers taking responsibility for program design and provider selection within income-based solutions. UTC has its own way of doing things, but that does NOT mean it's the only way.

The benefit manager responds to you that she is concerned about her ability to sell the option to management. Do you have any pointers for her?

I would ask the manager, "Why does your management offer a retirement plan in the first place?" Then ask, "What do they expect it to achieve for their employees, and by extension, their organization?" If the plan is not designed to specifically address those objectives, then it is not likely to achieve them.

The reality is that all retirement plans involve risks and costs for the organizations that sponsor them and the people they serve. It's important to acknowledge this and work to reduce or eliminate uncompensated risks for all parties concerned. We don't have to achieve perfection to make things better.

You have lived with day-to-day management of this arrangement for several years. Would you recommend it to medium sized employers? If not, what would need to change before you would recommend it to medium sized employees?

A mid-sized employer could oversee and maintain the design that UTC has in place today as long as they have access to external service providers in the same way that UTC does. In fact, we've seen the offerings of our service providers develop to the point where they will take on virtually all of the functions that UTC manages internally. The employer still has a duty to monitor, select and replace those service providers, but that is no different than the duty they have today with their existing programs.

What else would you like to tell us?

Keep coming up with great ideas . . . we ain't done, yet. ■

Kevin T. Hanney, CFA, is senior director, Pension Investments, for United Technologies Corporation (UTC). His leadership, advocacy, and innovation leading to lifetime income in defined contribution plans has been widely recognized.