IMPORTANT RESEARCH ON INCOME AFTER RETIREMENT AND DC PLANS

AN INTERVIEW WITH STEVE VERNON

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INTRODUCTION

The Society of Actuaries Committee on Post-Retirement Needs and Risks in partnership with the Stanford Longevity Center is sponsoring a series of research projects to further our knowledge about lifetime income and DC plans, and to help make it more attractive for plan sponsors to include a variety of income options.

The 2013 report, "The Next Evolution in DC Plan Design," establishes a foundation and guide for employers to move forward based on current knowledge. The 2014 report, "Foundations in Research for Regulatory Guidelines on the Design & Operation of Retirement Income Solutions in DC Plans," discusses the regulatory challenges to employers and establishes a framework for safe harbors that would make employers more comfortable with options. Additional work now underway is examining efficient frontiers. That work will be published in 2015. Steve Vernon is one of the principal authors of these reports, and he's collaborating with Joe Tomlinson, FSA, and Dr. Wade Pfau, professor of retirement income at The American College.

WHY ARE INCOME SOLUTIONS IMPORTANT FOR PLAN PARTICIPANTS?

Retirement income programs can significantly improve the financial security of retirees, for several reasons. It's easier for many plan participants to manage their finances in retirement if they receive a regular paycheck that will be reliably paid for the rest of their lives. When you think about it, most workers manage their monthly finances around their regular paycheck. The amount of that monthly check imposes a financial discipline; you can't spend much more than your paycheck over the long run. So it's only natural to continue managing your monthly finances through the discipline of a regular retirement paycheck that lasts for the rest of your life, no matter how long you live.

Traditionally that paycheck has come from Social Security and defined benefit plans. Most of today's new retirees, however, will need to determine how to generate a monthly check from their IRA and 401(k) accounts, to supplement their Social Security income.

This task is complex and is beyond the skills of most retirees. Plan sponsors can help improve the retirement security of their participants by offering programs of retirement income in their DC plans. This will make it possible for plan participants to select and implement a retirement income strategy that works for their goals and circumstances.

Plan sponsors are well suited to hire advisors to carry out the analysis and due diligence to design, implement, and communicate these programs. Our 2013 Next Evolution report estimated that plan participants could increase the amount of retirement income by 10 percent to 20 percent by utilizing institutionally priced retirement income solutions compared to retail solutions.

WHY IS THE REGULATORY FRAMEWORK FOR INCOME SOLUTIONS IMPORTANT?

Plan sponsors are concerned that if they offer retirement income solutions in their DC plans, they would incur fiduciary exposure if a plan participant elected a retirement income solution and later experienced unfavorable results. It would encourage them to implement retirement income solutions if they had a safe harbor for the retirement payout phase that is analogous to the investment safe harbors under ERISA Section 404(c) for the accumulation phase.

With this accumulation phase safe harbor, if a plan sponsor complies with requirements for the design, administration, and communication of investment options offered in the plan, then it has a defense against claims that a participant experienced unfavorable investment results. In the payout phase, plan sponsors would like similar guidelines for

the design, administration, and communication of payout options, such that they are protected in the event that plan participants experience unfavorable outcomes in retirement, such as income not keeping up with inflation, poor investment returns reducing income, or outliving savings.

The use of target date funds skyrocketed after they were given legislative and regulatory encouragement from the Pension Protection Act of 2006. We're hoping for the same result with a regulatory framework for retirement income solutions.

WHAT MIGHT BE INCLUDED AS KEY ELEMENTS OF A SAFE HARBOR?

We suggest using the 404(c) safe harbor regulations for the accumulation phase as a template for structuring guidance that applies to the payout phase. The 404(c) investment guidelines call for offering at least three investment choices that have distinct characteristics and risk profiles. Similarly, we suggest that a plan sponsor offer at least three possible methods to generate retirement income, each with distinct characteristics, as follows:

- Systematic withdrawals, where savings are invested in plan assets, and the plan pays the participant a periodic income using a payout strategy that is intended to last for life, but with no guarantees.
- Annuities, where an insurance company guarantees a lifetime retirement paycheck.
- A temporary payout over a fixed number of years, to enable delaying Social Security benefits or to provide a stream of payments until another form of income starts, such as an Advanced Life Deferred Annuity (ALDA) (also known as a qualified longevity annuity contract, or QLAC).

Similarly, safe harbor guidelines for the payout phase would enable a participant to divide their savings between two or more retirement income solutions. Also, there would be minimum disclosures to enable participants to make informed decisions.

HOW CAN ACTUARIES GET INVOLVED IN EXPANDING THE USE OF INCOME OPTIONS?

Actuaries are ideally qualified to design and communicate a program of retirement income in a DC retirement plan. Actuaries are trained to design products and services to address financial risks in retirement, such as outliving savings and keeping pace with inflation. This has the potential to be a major new area of practice for consulting actuaries.

WHAT ARE THE MAJOR TOPICS COVERED IN THE RESEARCH REPORTS?

The 2013 report, "The Next Evolution in DC Plan Design" provides a guide to DC plan sponsors and their advisors for design-

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ing and implementing programs of retirement income. It defines various retirement income generators (RIGs), summarizes their advantages and disadvantages, and projects how much income they generate during expected, favorable, and unfavorable investment scenarios. It contains a checklist for plan sponsors and their advisors to follow when designing a retirement income program. This report also contains a discussion of the fiduciary issues written by prominent ERISA attorneys.

The 2014 report "Foundations in Research for Regulatory Guidelines on the Design & Operation of Retirement Income Solutions in DC Plans" uses analyses and forecasts from the 2013 report to discuss possible safe harbor guidelines that could encourage plan sponsors to implement retirement income programs. For those plan sponsors who have compelling reasons to implement retirement income programs before such safe harbor guidelines are promulgated, the report provides a framework for developing a retirement income program for plan sponsors who are willing to rely on the prudent person rule for making fiduciary decisions.

Both reports are a good way for actuaries to learn about the relevant issues with designing and implementing retirement income programs.

WHAT REACTION HAVE YOU GOTTEN TO THE REPORTS?

I've presented the results at 10 professional conferences and two webinars, and reaction has always been quite favorable. Since this is such an important challenge for our society, professionals are hungry for the insights that our reports are providing, both to discuss the methods of the analyses and the results.

WHAT IS COMING IN THE NEXT PHASE OF THE WORK?

We're currently examining retirement income solutions in DC plans that can be considered optimal, according to specified criteria. We're using stochastic forecasting techniques together with efficient frontiers, and we intend to examine retirement income solutions that can be currently and realistically offered in DC retirement plans. We're comparing solutions that combine systematic withdrawals with immediate annuities, guaranteed lifetime withdrawal benefits (GLWB), and stand-alone annuity and systematic withdrawal methods.

We're also projecting results using qualified longevity annuity contracts (QLACs), and deferred annuities that are purchased in the period leading up to retirement. Both of these solutions were enabled by recent Treasury regulations. We're excited about these phases of our project because we'll be analyzing whether more complicated retirement income solutions produce better projected results than simpler solutions. While these more complex solutions are receiving a lot of general attention in the retirement industry, there's not a lot of detail on how you'd actually design a real-life application. That's where we intend to fill the gap of knowledge.

We're grateful to the Society of Actuaries for sponsoring this exciting and important research! ■