Retirement Income Planning in a DC World

Steve Vernon

Part Two of the series "Research That Matters Today"

Older workers face a series of critical decisions as they approach retirement[1]:

- When can they retire?
- How will they decide if they have enough savings to be able to afford to retire?
- How can they generate reliable retirement income from their Social Security benefits and savings?
- Which living expenses can they reduce in order to live on a reduced budget?

These decisions are more complex, and come with higher stakes, than the savings and investing decisions these workers made throughout their working years. How can plan sponsors help their pre-retirees make effective decisions? How can ordinary workers retire in a defined contribution (DC) world?

A significant body of research completed between 2013 and 2019 by the Stanford Center on Longevity (SCL), collaborating with the Society of Actuaries (SOA), provides insights into these important questions.[2,3,4,5,6,9] Three of these reports identify and analyze a straightforward retirement income strategy that can work well for most middle-income pre-retirees and can be implemented in virtually any DC plan or IRA. It's called the *Spend Safely in Retirement Strategy,* or the *Spend Safely Strategy* for short.

The economic turmoil we've experienced in 2020 reinforces the need for a straightforward retirement income strategy that generates a reliable income stream. This turmoil has left retirees and those nearing retirement concerned about their economic future and often confused about what to do next. With the right resources, employers can help them make informed and effective retirement planning decisions that are critical in uncertain times.

Introducing the *Spend Safely in Retirement Strategy*

The most recent SCL/SOA report (2019) analyzes the *Spend Safely Strategy* in detail.[2] This strategy has two steps:

Step 1. Optimize Social Security benefits by delaying the start of benefits for as long as possible, but no later than age 70. There's no financial advantage to delaying the start of benefits beyond age 70.

Pre-retirees can use one of two possible ways to delay starting Social Security benefits:

1. If possible, work part time, earning enough income to replace the Social Security benefits that are being delayed, or
2. Use a portion of retirement savings to fund a Social Security bridge payment, which temporarily substitutes for the estimated income they'll receive from Social Security until they actually start their Social Security benefits.

   SCL/SOA research demonstrates that a Social Security bridge payment can generate more retirement income than other retirement income generators.[4,5]

Step 2. Implement a straightforward strategy to generate retirement income from savings to supplement Social Security benefits. To accomplish this goal, invest retirement savings in a low-cost balanced, target date, or stock index fund. Then use the IRS required minimum distribution (RMD) rates to determine the amount to withdraw from savings each year. Use the same RMD methodology to determine annual withdrawals before the age when the rules actually apply (which was increased from age 70 to 72 by recent legislation).

The 2017 SCL/SOA report analyzed and compared 292 different retirement income strategies, using stochastic forecasts and efficient frontiers, analytical techniques that many large pension plans use to devise funding and investment strategies.[3] The *Spend Safely Strategy* compared favorably to these 292 strategies using eight different metrics described in the report. Those metrics included:

- the average inflation-adjusted amount of retirement income received throughout retirement,
- protection against inflation, and
- the average inflation-adjusted amount of wealth that can be accessed throughout retirement.

The 2019 SCL/SOA report also analyzed the *Spend Safely Strategy* for retirees in "average," "above average," and "poor" health, as defined in the report.[2] It concluded that the *Spend Safely Strategy* was viable for all three health categories. However, retirees who've received an actual diagnosis of a life-shortening disease might need a solution that's customized for their circumstances, which would recognize the financial needs of a spouse, among other factors.

Finally, it's important to recognize that the *Spend Safely Strategy* isn't rigid; the 2019 SCL/SOA report discusses several possible refinements to the strategy to personalize it to individual situations.[2] For example, older workers who aren't able to delay Social Security benefits until age 70 will still realize significant advantages by delaying benefits to their full retirement age or late 60s.

How Can Defined Contribution Plan Sponsors Help?

Plan sponsors can help their plan participants implement the *Spend Safely Strategy* by offering a basic retirement income menu in their DC plan, whether that's a 401(k), 403(b), or 457 savings plan. With such a menu, participants could allocate their savings among various retirement income options and implement these solutions within their plan by simply "checking the box."

A robust retirement income menu would include at least these three options:

1. A fixed monthly installment payment for a specified period to fund a Social Security bridge payment
2. Monthly installment payments using the IRS RMD or other withdrawal strategies, coupled with a low-cost balanced, target date, or stock index fund. These payments would be paid indefinitely, but remaining funds could be redeployed at any time.
3. An annuity to supplement Social Security with additional guaranteed lifetime income

A straightforward way to deliver the third option—an annuity—would be to facilitate an IRA rollover to an online annuity bidding service. Another possibility would be to implement annuities that are delivered in-plan, if the plan sponsor decides that would be advantageous to their participants.

Under the retirement income menu, the default payout option would be the IRS RMD rates, starting at age 70 or 72 when the rules actually apply, coupled with the plan's qualified default investment alternative (QDIA). SCL/SOA research discusses how the design of the retirement income menu and default payout option can minimize any potential liability exposure a plan sponsor might have.[6, 7]

Plan sponsors can also help their participants by providing communications materials that help pre-retirees navigate their most critical retirement income decisions; this material should also clearly explain how the retirement income menu can support effective decisions. Parts Three and Four of this series explore these ideas in more detail.[7, 8] Plan sponsors can also help by creating part-time positions for their older workers to enable them to downshift from their full-time jobs but continue working in order to delay taking Social Security benefits.

Why Should Plan Sponsors Help?

Employees have traditionally looked to employers to help them with their retirement benefits and economic security plans. In a DC world, they receive a lot of help before retirement, but they're often on their own once they retire and leave the workplace. COVID-19 and the accompanying economic turmoil have created a great deal of insecurity and confusion about retirement security, which will probably last long after the health risks are under control. Fortunately, employers can take actions that will help employees develop a plan and alleviate much of the confusion. This is important because:

- Communication materials from plan sponsors can help older workers decide when they can afford to retire. If pre-retirees are unsure about this decision, they might delay retiring indefinitely. A retirement income menu can help an employer better manage an aging workforce.
- Retirement income solutions that use institutional pricing have the potential to increase retirement income by 10% to 20% compared to retail solutions, a result estimated by earlier SCL/SOA research.[9] Implementing a retirement income menu can result in a more efficient use of retirement plan contributions made by employers and their workers.
- A retirement income menu represents an inexpensive plan improvement that also elevates the plan from a simple savings plan to a true retirement plan.
- It helps reduce per-capita administrative costs by retaining retirees' assets in the DC plan.
- Employers can retain institutional knowledge by continuing to employ older workers and retirees.
- The enhancements discussed in this essay are the right thing to do for older workers and retirees. They also set a good example to younger workers on how the employer treats their workers at any age.

In recent years, plan sponsors have enhanced their plans to boost retirement savings through auto-enrollment, low-cost investment funds, and default investment solutions. The time has come to take the next step in the evolution of DC retirement plans. DC plan sponsors can now use respected research to help their pre-retirees make and implement critical retirement decisions.

Steve Vernon, FSA, is a Research Scholar, Stanford Center on Longevity, and co-author of the SOA-sponsored research report *Viability of the Spend Safely in Retirement Strategy,* which forms the foundation for the ideas in this series of essays. Vernon is also the author of a consumer-facing book based on this research: *Don't Go Broke in Retirement: A Simple Plan to Build Lifetime Retirement Income*. He can be reached at steve.vernon@restoflife.com.

References

The SCL/SOA reports and essays identified below include the analyses that support the conclusions discussed in this article and also address the implementation issues and refinements to the *Spend Safely Strategy*. The last reference listed is a consumer-friendly book designed to help middle-income pre-retirees and retirees understand and implement the *Spend Safely Strategy.*

1. *The 5 Most Important Retirement Income Decisions*, by Steve Vernon, FSA. First in the series "Research That Matters Today," Society of Actuaries, July 2020.
2. *Viability of the Spend Safely in Retirement Strategy*, by Wade Pfau, Ph.D., Joe Tomlinson, FSA, and Steve Vernon, FSA. Society of Actuaries, May 2019.
3. *How to "Pensionize" Any IRA or 401(k) Plan,* by Steve Vernon, FSA. Stanford Center on Longevity, March 2018.
4. *Optimizing Retirement Income by Integrating Retirement Plans, IRAs, and Home Equity: A Framework for Evaluating Retirement Income Decisions,* by Wade Pfau, Ph.D., Joe Tomlinson, FSA, and Steve Vernon, FSA. Society of Actuaries, November 2017.
5. *Optimizing Retirement Income in Defined Contribution Retirement Plans: A Framework for Building Retirement Income Portfolios,* by Wade Pfau, Ph.D., Joe Tomlinson, FSA, and Steve Vernon, FSA. Society of Actuaries, May 2016.
6. *Foundations in Research for Regulatory Guidelines on the Design and Operation of Retirement Income Solutions in DC Plans,* by Steve Vernon, FSA. Society of Actuaries, September 2014.
7. *Consider a Default Process for Retirement Income Options in DC Retirement Plans,* by Steve Vernon, FSA. Third in the series "Research That Matters Today," Society of Actuaries, July 2020.
8. *Retirement Income Statements That Educate and Don't Confuse,* by Steve Vernon, FSA. Fourth in the series "Research That Matters Today," Society of Actuaries, July 2020.
9. *The Next Evolution in Defined Contribution Retirement Plan Design: A Guide for DC Plan Sponsors to Implementing Retirement Income Programs,* by Steve Vernon, FSA. Society of Actuaries, September 2013.
10. *Don't Go Broke in Retirement: A Simple Plan to Build Lifetime Retirement Income,* by Steve Vernon, FSA. *Rest-of-Life* Communications, Summer 2020.