

WHITE PAPER

It's Time For A Change

The Need for Next-Generation
Retirement Income Solutions





The industry needs **true innovation** to solve for the core reason workers invest in their retirement plans – to accumulate an asset base that will generate a secure stream of lifetime income.

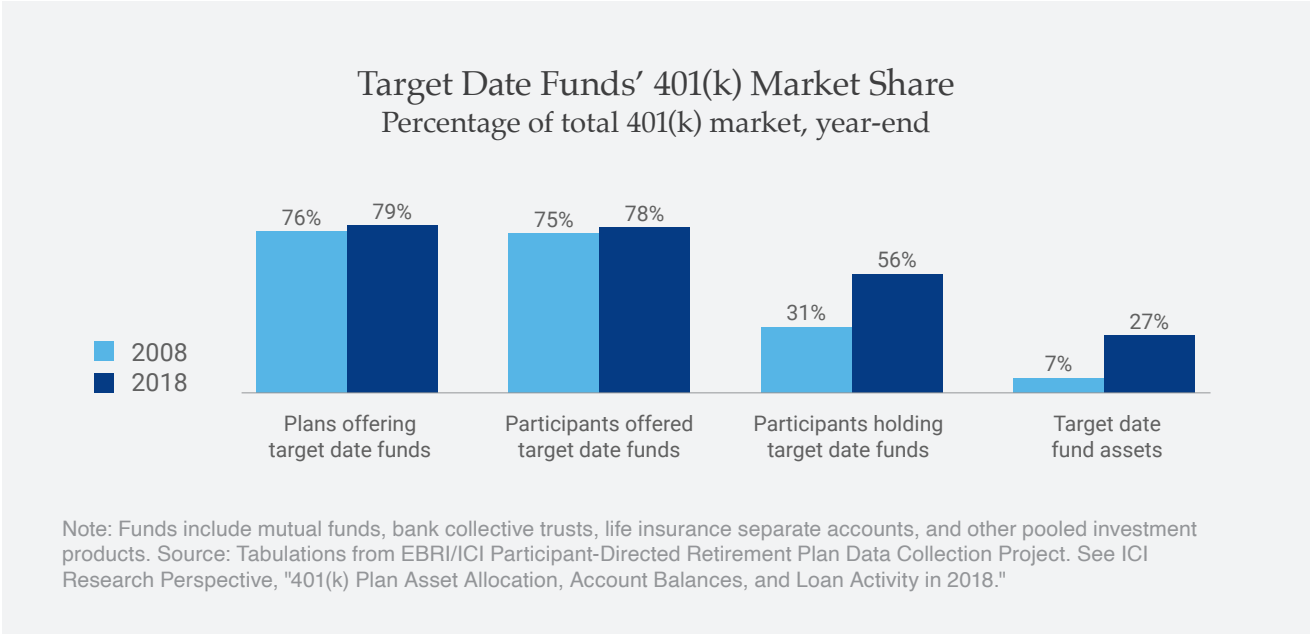
Executive Summary

- U.S. retirees are at risk of being unable to maintain their pre-retirement standard of living based on current savings levels, and growing life expectancies only exacerbate the problem, as longevity magnifies all other retirement risks.
- With the decline of DB plans, and rise of DC plans, participants now hold the burden of generating their own wealth and converting it into sustainable retirement income – a task many are ill-equipped to successfully handle on their own.
- Accumulation-focused target date funds (TDFs) have become the darling of the DC investment world, and have materially improved many DC participants' ability to save, yet to date no TDFs offer a thoughtful and protected income and growth drawdown solution.
- The desire for retirement income solutions for DC plans is apparent – from participants, administrators, and plan sponsors. Yet, lack of vision and innovation have led to low adoption of first-generation income products.
- Annuities were originally designed to sit alongside an individual's retirement portfolio – not to be integrated into an institutional platform. Forcing an annuity onto an investment platform has created product deficiencies of limited growth, decision paralysis, lack of control and antiquated product design.
- The industry needs to stop looking for a solution among the products that currently exist and create a true innovation that will overcome historical deficiencies while delivering better benefits to the participant.

Solving the Retirement Income Crisis

A primary concern of U. S. workers today is securing adequate retirement income that will support them through retirement.¹ Their concerns are valid as statistics show half of U.S. retirees are at risk of being unable to maintain their pre-retirement standard of living based on current savings levels.² For most workers, their workplace retirement plans have been the most effective way to accumulate assets,³ and will provide the greatest portion of replacement income in retirement (36 percent).⁴ Over the past 40 years, 401(k) plans, which focus on do-it-yourself asset accumulation, have become the most prevalent employee retirement plan offered in the workplace,⁵ displacing defined benefit (DB) plans, under which employers guaranteed retirement income to participants. Workers in defined contribution (DC) plans now shoulder the responsibility to both amass wealth and generate retirement income on their own. Many are at a disadvantage because they lack the knowledge and investment products and solutions to address critical threats to retirement income, including longevity risk and sequence of returns risk. What is needed to address this critical gap is next-generation retirement income solutions that are compatible with DC plans.

With the decline of DB plans and rise of DC plans, very few participants have access to the type of income-focused solutions within their retirement plans they need to solve for the financial risks they will face during their retirement years. Only nine percent of plans surveyed offer any type of guaranteed lifetime income option.⁶ Instead, accumulation-focused target date funds (TDFs) have become the darling of the DC investment world, with 80 percent of DC plans offering them.⁷ TDFs invest in a changing mix of equities and fixed-income investments. As the fund approaches and passes its target date (which is usually specified in the fund’s name), the fund gradually reallocates assets from equities to fixed-income investments, including bonds.

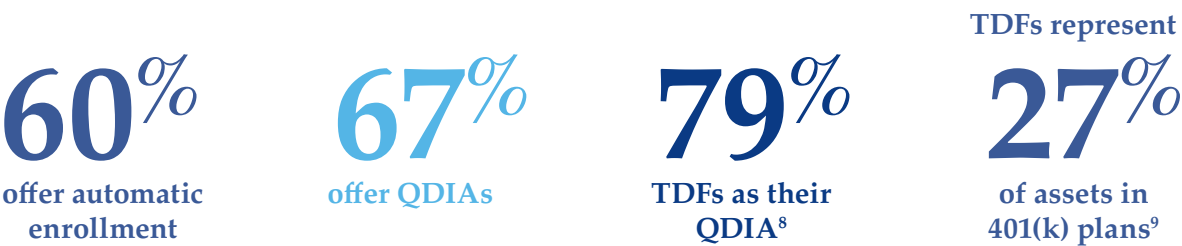


1. American of Financial Services, 2020. 2. Center for Retirement Research at Boston College, THE NATIONAL RETIREMENT RISK INDEX: AN UPDATE FROM THE 2019 SCF, January 2021. 3. PEW Issue Brief, "Workplace Retirement Plans Tend to Sharpen Focus on Financial Futures," February 2018 4. Social Security Administration (SSA), Improving the Measurement of Retirement Income of the Aged Population, 2021. 5. Plan Sponsor Council of America, 63rd Annual Survey, 2020. 6. Ibid. 7. Ibid.



The growth of TDFs as the predominant investment vehicle in 401(k) plans has been phenomenal, resulting from the creation of qualified default investment alternatives (QDIAs) and the popularity of the automatic enrollment plan design feature.

Consider these 401(k) plan statistics:



As the leading type of QDIA in DC plans by far, TDFs have materially improved many DC participants’ ability to save. Yet, TDFs fall short when it comes to converting savings into retirement income. Many plan sponsors and participants do not fully understand TDFs and fail to recognize that today’s TDFs lack a satisfactory mechanism for generating guaranteed lifetime income or offering downside protection.

As more Baby Boomers retire, the topic of how to generate retirement income that will last their lifetime has become pressing. The number of Americans age 65 and older will more than double by 2060.¹⁰ Growing life expectancies only exacerbate the problem, as longevity magnifies all other retirement risks. **For workers nearing or at retirement, the most important attribute of a retirement savings plan is to, "...help me understand how much I can safely spend in retirement."**¹¹ The changing demographics all but require a better QDIA solution to solve for the income replacement needs of Americans. To date, no TDF offers a thoughtful and protected income and growth drawdown solution.

8. Ibid. 9. ICI Issue Brief, 401(k) Asset Allocation, Account Balance and Loan Activity in 2018, March 2021. 10. Population Reference Bureau analysis of data from the U.S. Census Bureau. 11. American College of Financial Services, 2020 Retirement Income Literacy Survey, 2020.

New Legislation Opens the Door for Income Solutions

Lawmakers and regulators recognize there are serious flaws and deficiencies in the DC retirement income solution set today. Consequently, they are drawing more attention to the need for guaranteed lifetime income options for retirees, sending every signal for the industry to finally solve this looming gap. Consider the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act 1.0). Under this new law, effective for 2020 and later years, plan sponsors were given multiple lifetime income tools (see Exhibit A).

On the horizon, the proposed Securing a Strong Retirement Act of 2021 (a.k.a., SECURE Act 2.0) would continue the administration’s support of improving retirement income solutions by defining a method of benchmarking TDFs, which would help plan sponsors better assess these options as prudent investment alternatives and create opportunities for next-generation products that would deliver guaranteed retirement income to plan participants. Additionally, as proposed, SECURE Act 2.0 contains three additional provisions supporting lifetime income in DC plans, which, if finalized, would do the following (see Exhibit B).

Exhibit A

SECURE Act 1.0 lifetime income tools:

- A mandate to translate DC plan account statement balances into equivalent monthly income payments and joint and survivor benefit amounts for plan participants
- A safe harbor for selecting lifetime income (annuity) providers
- More favorable portability options between differing DC plan types for lifetime income products in DC plans in the form of a qualified plan distribution annuity

Exhibit B

SECURE Act 2.0 additional provisions:

- Remove RMD barriers for life annuities
- Enhance qualifying longevity annuity contracts
- Update regulations for insurance-dedicated exchange-traded funds

Clearly, DC plan income solutions and proposals have been limited to annuities – which begs the question: **Are annuities the right retirement income solution? Sponsors and participants are skeptical.**

That’s not to say that they are against a change. On the contrary, DC plan sponsors are on board with an industry overhaul of retirement income options. More and more, they want to offer a “through-retirement glidepath” in their plans. Among sponsors of large plans, 74 percent prefer to keep their 401(k) plan participants in the plan post retirement – an increase of 28 percentage points from six years ago.¹² With this goal in mind, they have identified their top priorities for their DC plans as:

DC plan sponsors are on board with an industry overhaul of retirement income options.

- **Scrutinizing TDFs more closely**
- **Evaluating fees**
- **Incorporating retirement income solutions¹³**

The skepticism, therefore, is mainly around making the right choices as they update their plans. It boils down to a plan governance issue. Sponsors need advisors’ help with designing and operating their DC plans to deliver guaranteed lifetime income, which involves aligning the Investment Policy Statement, the plan document provisions, the service providers and the plan’s investment options. And before they can align, sponsors need to feel comfortable and confident in their assessment and choice of guaranteed income solution.



First-Generation Retirement Income Offerings Fall Short

Participant, administration, and plan sponsor desire for retirement income solutions for DC plans is apparent. **So why haven't first-generation solutions reached mainstream adoption? The answer is a lack of vision and innovation.**

While it is true that the risks people face in retirement can be mitigated through the purchase of an annuity, annuities were originally designed to sit alongside an individual's retirement portfolio – not to be integrated into an institutional platform. Providers have ineptly “bolted” retail annuities onto institutional investment platforms akin to forcing a square peg in a round hole. The resulting outcome has been less than satisfying, merely squeezing one participant need to fill another (e.g., growth for income).

Annuities were originally designed to sit alongside an individual's retirement portfolio – not to be integrated into an institutional platform.



Traditional retirement income offerings such as annuities come with historic deficiencies and problems once they are integrated into a DC platform. In order to deliver income guarantees, they have forced participants to give something up in return. First-generation income product deficiencies include:



Growth limitations

By electing an annuity, often the plan participant will have to sacrifice upside market growth and equity exposure.



Decision paralysis

Most Americans do not have the knowledge to accurately determine their future income needs, and current in-plan income solutions can be difficult to understand. Product solutions need to consider the participant experience – at enrollment, when the annuity contract is established, and at retirement – and stop requiring participants to make decisions they are ill-equipped to make.



Antiquated product design

The current structure of annuities does not fit well on asset management platforms, like those for DC plans. This draws down the efficiency of the product for all parties – and the overall benefit for the participant.



Lack of control

Once an in-plan annuity is purchased, the participant often gives up control of his or her money in return for a future retirement benefit. If for any reason the participant's situation changes, this lack of control can end up limiting the participant's options.

Additionally, today's in-plan retirement income products are not easily portable from recordkeeper to recordkeeper, or even to an IRA. Participants run the risk of forfeiting their accrued income benefit.

Impractical solutions lead to low adoption

Not only are individuals ill-equipped to handle the retirement realities they face today, the available solutions are impractical. The benefit (income) up until this point has not been worth the tradeoffs. Insurance and annuity products (e.g., single premium immediate annuities, deferred income annuities, and variable annuities with guaranteed minimum withdrawal benefits) have attempted to solve plan participants’ need for lifetime retirement income. But the current products have material deficiencies when wrapped as a component of an institutional retirement portfolio, and are not widely available through DC plans (only nine percent offer them).¹⁴

The benefit (income) up until this point has not been worth the tradeoffs.

Annuities can offer advantages in terms of retirement income certainty, however legacy annuity products within DC investment menus were often not worth the costs, complexity and confusion. Americans face an income crisis, and a more sophisticated approach to product evaluation and selection is necessary beyond simply ascertaining the amount of monthly income a specific product provides. The retirement industry must respond with new and more robust retirement income products that will change how plan officials assess and select such products. As the new products overcome the traditional problems and limitations, we can then focus on the most important element in the retirement income evaluation equation – safely optimizing participants’ retirement income benefit.

14. Plan Sponsor Council of America, 63rd Annual Report, 2020.

We analyzed the most common products used in first-generation in-plan income products. We structured this analysis in two parts: first, we assessed **product attributes** that lead to the common historical deficiencies outlined earlier in this paper. Then, we assessed the **participant’s retirement benefit** – including accumulation value, the income guarantees, and the mitigation of risk.

	Managed Payout Funds		Deferred Income Annuities and Single Premium Immediate Annuities		Variable Annuities with guaranteed lifetime withdrawal benefit	
PRODUCT ATTRIBUTES						
Growth Potential		Participates in equity markets		Limited opportunity for growth or equity exposure		Participates in equity markets, subject to investment restrictions
Simplicity		Automated process for participants for the life of the product		Requires decisive action from participant at annuity purchase point		Requires decisive action from participant at annuity purchase point
Product Efficiency		No underlying annuity, income will vary		Individual annuity offered alongside group asset management platform		Individual annuity wraps asset management platform, causing investment restrictions and additional fees
Control		Assets fully liquid and portable for the life of the product		Assets remain liquid until annuitization. Limited portability on plan and participant level		Assets remain liquid until annuitization. Limited portability at plan and participant level
PARTICIPANT BENEFITS						
Lifetime Income		No income guarantees		Guaranteed lifetime income		Guaranteed lifetime income
Accumulated Value		Full accumulation potential		No accumulation potential within the annuity		Some accumulation potential, additional fee to provide guarantees drags down portfolio return
Risk Mitigation		Subject to longevity and sequence of returns risk		Mitigates longevity risk		Mitigates longevity risk, may be subject to sequence of returns risk

The Way Forward

The time has come to incorporate true *solutions* – which go beyond an income benefit – into DC plans. The industry needs to stop looking for a solution among the products that currently exist. It needs innovation: new products that are designed specifically to deliver maximum participant outcomes in retirement without sacrificing growth potential, control, product efficiency or simplicity.



Growth Potential

The solution should present participants an acceptable level of equity exposure and market risk and asset managers should be free to invest in portfolio funds without insurance company interference or restrictions.



Product Efficiency

The solution should not “bolt on” or “wrap” products that currently exist yet have no means of working efficiently together. Instead, all elements, from the annuity to the investment holdings to the glidepath, should be integrated seamlessly together into one single design. This will remove the need for additional charges or fees to fund the guarantees and remove many of the experience and control challenges participants have seen in the past.



Flexibility and Control

Participants should not have to give up control over any portion of their assets, even after the solution begins funding an annuity or when income payments start. Additionally, participants should be able to maintain their accumulated income guarantee if rolling assets out of the plan. Plan sponsors should also maintain control, with the ability to easily and efficiently migrate the plan to a new recordkeeping platform.



Simplicity

Solutions should be QDIA-eligible and require no participant actions or decisions to begin automatically funding the embedded annuity – or at any time prior to retirement. Instead, participants should only be required to make decisions at the point they are well equipped to do so. For many, that will be at the time of retirement.

The right TDF could – and should – solve for the aforementioned deficiencies. And to do so, the income component must be embedded directly into the portfolio. To embed the annuity within a portfolio, however, requires a fundamental change in how the annuity works. The annuity must maintain its core functionality in delivering income and reducing risk, while acting and trading like an investment. This is a shift in the way the industry has always looked at this vehicle – and requires product innovation.

Only then, once the annuity is fundamentally transformed, can a TDF embed the annuity directly into its portfolio. And in doing so, it will change everything. A TDF with embedded income has the ability to efficiently and effectively offer the strong accumulation that participants have always expected, while additionally providing guaranteed lifetime income and mitigating critical retirement risks.



Conclusion

The retirement services industry is long overdue for true innovation to solve for the core reason workers invest in their DC retirement plans – to accumulate an asset base that will generate a secure stream of lifetime income upon retirement. The next-generation product leaders will need to deliver strong lifetime income benefits that allow for growth to produce better long-term value, while providing full liquidity along the way. New product designs must put participants' needs first. At a minimum, any solution must address the foundational deficiencies of first-generation products. A next-generation TDF, one with embedded lifetime income guarantees, checks all the essential boxes.

About The Retirement Learning Center

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