January 2014

Helping participants generate a lifetime of income

TIAA CREF

Financial Services

At the beginning of the 1980s, defined benefit plans were the dominant retirement approach in the U.S. — 30 million Americans were covered by them. However, those plans are dwindling in number. As of 2010, the number of Americans covered by DB plans was only about 17 million. More than four times that many Americans were covered by defined contribution plans in 2010, the most recent year for which data is available.[1]

What is your plan producing?

"We are now evolving into the next generation of success standards [for 401(k) plans]. The new measurement will be based on back-end results. Rather than: "What is the plan doing?" the question will be: "What is the plan producing — will it yield adequate benefits for participants to live on in retirement?" Success will be measured not by account balances but retirement income. After all, the need for benefits in retirement is month-to-month and not lump-sum."

— Fred Reish, Chair of Financial Services ERISA practice at Drinker, Biddle & Reath

To be sure, some participants will have the discipline to capitalize on the "do-it-yourself" ethos of DC plans. They will save at the necessary level; they will consistently make the right investment moves; and they will avoid the many missteps that are possible in retirement.

But the number of people who manage to do all of those things will be small. That means, if you are a plan sponsor, that you will need to help them on the road to retirement.

It's likely that you have put a lot of effort into helping your participants accumulate a sizable retirement account. But if wealth accumulation is the primary yardstick of your defined contribution plan, you are only giving participants half of the solution. They also need your help in turning their wealth into income that will last them their whole lives, the way pensions did in the heyday of defined benefit plans. Offering guaranteed-income options within a retirement plan increases the likelihood that your employees will have a stream of income that allows them to live comfortably in retirement.

Minimizing the risks of retirement

A good place to begin is by asking where defined contribution plans *ought* to leave participants when they retire, which speaks directly to a plan sponsor's fiduciary duties. A well-run DC plan should help participants become retirement ready. It should:

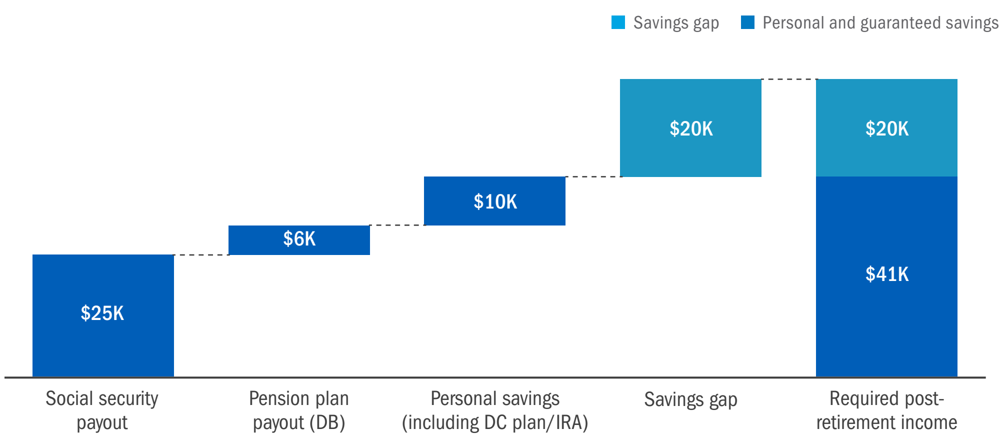
- Put participants on track to generate between 70% and 90% of the income they made during their working years[2]
- Offer participants advice and guidance that will help them navigate the inherent risks of the financial markets
- Give participants options for lifetime income to ensure that they do not run out of money

"Guaranteed income": Clarifying the term

"Income" is so much a part of investing nomenclature that it can be easy to miss important distinctions. Most mutual fund companies and virtually every 401(k) plan offer some form of "income fund" or "growth and income" fund. But the income from these investments fluctuates based on what's happening in the market, on trends in interest rates, and on the performance of the underlying securities (usually bonds). There may be goals for income, and there are certainly benchmarks, but there is no actual guarantee of lifetime income. An annuity, however, guarantees an income stream that a person cannot outlive. Only an insurance company can offer this form of guaranteed lifetime income.[3]

However, plans that are focused on accumulation rather than retirement income are unlikely to be able to meet the retirement readiness goals of their employees. The accumulation model is leaving many retirees without the savings and the income they will need to last through their retirement years, as illustrated by a recent McKinsey study: The typical middle-class household can expect to receive approximately $20,000 per year less in retirement income than the $61,000 needed on average — translating into an overall shortfall of nearly $250,000 per household (see Exhibit 1).[4]

Exhibit 1: The average middle-class household is not on track to have enough income in retirement



Note: This analysis represents a household with $50k to $100k in annual income, where the head of the household is a pre-retiree (40 to 59 years old).

Source: McKinsey Retirement Readiness Index Model 2012

Even those people lucky enough to have amassed substantial nest eggs in 401(k), 403(b) and 457 plans are essentially on their own when it is time to turn their savings into income. They may set up systematic withdrawals based on their required minimum distributions, and hope for the best. They may try to follow some form of the 4% guideline — a rough rule of thumb for how much can be withdrawn from a retirement portfolio each year without its ever being depleted.

But these approaches to withdrawing savings expose retirees to considerable risk. There is, to begin with, longevity risk. It is simply harder to make money last if you live to 90, 95 or 100 — no longer so unusual — than if you have the typical U.S. lifespan of 76 for a man or 81 for a woman.[5]

Second, there is the risk that the underlying investments won't perform as well as expected — an especially big problem if a sharp downturn happens during the first few years of retirement, when it can render the 4% withdrawal rule irrelevant (and potentially dangerous). (See Exhibit 2.)

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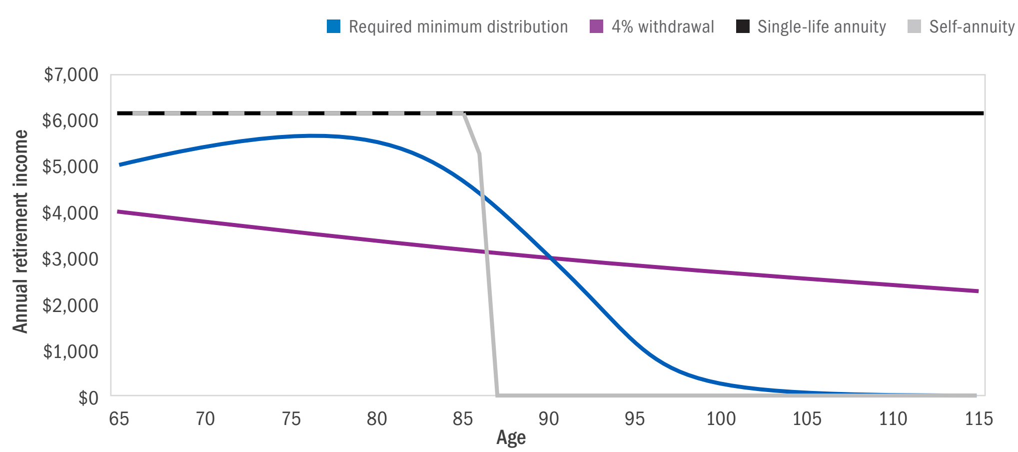
Third, there is the risk of retirees losing their mental acuity, and their ability to make effective financial decisions about investments or withdrawals. Finally, there are the healthcare costs that are a virtual certainty in retirement. The average retired man will need $124,000, and the average retired woman $152,000, to cover these costs alone, according to the Employee Benefit Research Institute.[6]

Adding guaranteed income options to retirement plans

Plan sponsors may wonder why they need guaranteed income options in their plans, instead of allowing participants to investigate these options upon retirement. But having these options within DC plans makes it more likely that participants will take advantage of them in retirement.

Exhibit 2: A single-life annuity offers consistent income throughout retirement



This model assumes that a person has annuitized $100,000 at age 65 at a 3% interest rate. For illustration purposes only. Actual payouts may differ. Three percent nominal interest rate return assumption for all calculations. Single Life Annuity (SLA) based on 3% payout rate. Self-annuity payout (in which a person takes the needed amount out of savings rather than annuitizing) set to replicate payout amount of the SLA. Required minimum distribution payout uses Social Security unisex mortality table for remaining life expectancy. All amounts are pretax.

Source: Richardson, David P. (2012) "The Role of Guaranteed Income in Improving Retirement Security." TIAA-CREF Institute Working Paper.

Fiduciary considerations

From a fiduciary perspective, the process for selecting annuities is not that much different from selecting mutual funds or making any other decision that can affect participants' retirement readiness, although the metrics might be slightly different.

To begin with, the plan sponsor must undertake an objective and thorough search of potential annuity providers. It must pick a provider that has consistently demonstrated the financial strength to make the agreed-on future payments. The plan sponsor should review expenses and features and prudently explore an effective trade-off (weighing fees and commissions against benefits and services). If the sponsor does all of these things (and a few others, such as working with an expert on the selection of an annuity provider), the plan will likely have fulfilled its fiduciary duty.

By offering annuities, plan sponsors can go beyond today's requirements and set a higher standard of fiduciary care. This came through in a Towers Watson survey in which 33% of annuity-offering plans rated themselves highly on helping participants at retirement. Only 20% of plans without annuities made the same positive self-assessment.

A recent study by the TIAA-CREF Institute found that individuals who contribute to annuities while they are saving are more likely to annuitize their retirement savings and receive retirement income in the form of lifetime annuity payments.[7] For instance, two in every five participants covered by TIAA retirement plans — in which annuities form the foundation of accumulation and distribution investment menus — annuitize a portion of their accumulated savings when they retire.

This is important because research indicates that many retirees would be better off annuitizing a large share of their retirement portfolios.[8] In fact, annuitizing is the only way to guarantee a consistent income stream in retirement that cannot be outlived.[9]

Although there are other guaranteed-income options, annuities are a critical option to consider. Annuities pay agreed-on sums at known intervals (usually monthly) as long as a retiree lives. Their "guaranteed" nature (see "Guaranteed income: Clarifying the term") can make them comparable to pensions in the security they may offer retirees about their future. Yet most plan sponsors and consultants have a number of concerns about annuities — that they are complex and expensive, for instance, or that they will be difficult to monitor and add to a plan sponsor's fiduciary burden.

In not offering annuities, however, plan sponsors are actually missing an opportunity to set a higher standard for retirement outcomes and participants' confidence in their ability to retire. Many personal finance experts already recommend that retirees cover their necessities — food, shelter and clothing — with guaranteed income sources. Rarely, though, is Social Security enough to anchor an individual's retirement in this way. The purchase of an annuity can make up the shortfall.

It isn't necessary for a participant to put 100% of his or her retirement savings into an annuity. In addition to the guaranteed income component, there should also usually be a return-seeking component consisting of some combination of stocks and bonds, perhaps in the form of target-date funds. But having an anchor in the form of annuity income is crucial.

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Becoming educated about annuities

Once plan sponsors include annuities on their investment menu, they can do a few things to increase participants' use of them. One is to put the annuity option in a prominent part of the investment menu — for instance, right next to the target-date funds, or whatever the plan uses as a qualified default investment alternative.

A second way of increasing the use of in-plan annuities is to provide guaranteed income projections in quarterly statements. Indeed, the U.S. Department of Labor has been weighing a proposal that would require defined contribution plans to provide a projection for monthly lifetime income to all retirement-plan participants.[10] The income figure, based on a set of assumptions about investment performance and participants' expected life spans, would allow people still working to envision the amount of income they could expect from their retirement accounts. If participants regularly got such information, it would thrust the potential of annuities into the spotlight.

Finally, employers who provide matches on 401(k), 403(b) and 457 contributions could possibly even stipulate that a minimum percentage of the matching funds be directed to an annuity. Such a provision could be especially prudent for those entities freezing or terminating their old defined benefit plan and adding a defined contribution plan as a replacement. To be sure, a rule like this would represent a big shift. But employers could justify it as being in the best interests of their employees, much as they do with automatic plan enrollment and escalation features.

Leading the way on lifetime income

Forward-thinking plan sponsors have an opportunity right now to be trailblazers. Their employees are quickly coming to recognize that accumulating a pot of savings for retirement is not enough; they need help turning that savings into income that will last for the rest of their lives.

Indeed, it's not hard to imagine that down the road, DC plans will see it as their obligation to include a core of pension-like guarantees, likely in the form of annuities. This transition just makes too much sense *not* to happen. Leading-edge plans don't have to wait for this trend to emerge. They can take steps now to help their employees prepare for the retirement they deserve.

About TIAA-CREF

TIAA-CREF (tiaa-cref.org) is a national financial services organization with $564 billion in assets under management (as of 12/31/2013) and is the leading provider of retirement services in the academic, research, medical and cultural fields.

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[1] www.dol.gov/ebsa/pdf/historicaltables.pdf

[2] The 70% to 90% figure includes income from Social Security and other sources.

[3] Guaranteed lifetime income is subject to the insurance company's claims-paying ability.

[4] McKinsey Retirement Readiness Index Model 2012

[5] CIA World Factbook: www.cia.gov/library/publications/the-world-factbook/geos/us.html

[6] Fronstin, Paul, Dallas Salisbury and Jack VanDerhei. "Funding Savings Needed for Health Expenses for Persons Eligible for Medicare." EBRI Issue Brief no. 351 (May 2010).

[7] Paul J. Yakoboski, "Retirees, Annuitization and Defined Contribution Plans," Trends and Issues, TIAA-CREF Institute, April 2010.

[8] Jeffrey R. Brown, "A Paycheck for Life: The Role of Annuities in Your Retirement Portfolio," Trends and Issues, TIAA-CREF Institute, June 2008.

[9] Yakoboski, April 2010.

[10] www.dol.gov/ebsa/newsroom/fsanprm.html

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