Consider a *Default Decision Process* for Retirement Income Options in DC Retirement Plans

By Steve Vernon, FSA, Research Scholar

Part Three of the series "Research That Matters Today"

The hunt is on to find a default retirement income option in defined contribution (DC) savings plans. Plan sponsors and their professional advisers are emboldened by default enrollment, auto escalation, and investment options that have successfully boosted participation and savings in DC plans. As a result, they want to tap the power of defaults and inertia to design a retirement income option that can effectively turn savings into reliable income for retiring participants. To be dramatic, default retirement options are the current "holy grail" of retirement!

But what if the holy grail was instead a *default education and decision process* that enables participants to make informed and effective decisions about deploying their savings in retirement?[1] This process would complement and support a thoughtful retirement income menu that a DC plan sponsor could implement that includes a strategic default retirement income option.[2]

There are critical differences between designing broad-based defaults for the accumulation phase and designing broad-based defaults for the payout phase. These differences involve protecting the plan sponsor from litigation, competing perspectives about effective retirement income options, and the practical difficulty that comes with designing a "one-size-fits-all" retirement income solution.

Let's explore these differences before reviewing the details of a default decision process.

STANFORD CENTER ON LONGEVITY

The Elephant in the Room

Given the litigious climate surrounding DC savings plans, plan sponsors are understandably reluctant to offer innovative plan features, including payout options. With this backdrop, let's examine the differences between the accumulation and payout phases.

Plan sponsors can minimize their legal exposure by following legislative and regulatory guidelines for auto enrollment, auto escalation, and default investment options. Unfortunately, there are no specific legislative and regulatory guidelines for any default retirement income option, except for one. The single option with such support involves:

- Investing assets in the plan's qualified default investment alternative (QDIA) that's applicable for retirees, which already has legislative and regulatory support, and
- Using the IRS required minimum distribution (RMD) rates to calculate the annual amount of retirement income distributed to retirees (the RMD is required by law and generates substantial penalties for noncompliance).

If you look closely at the fine print in the legal plan documents of many DC plans, they already include this default payout option—it's just not promoted to plan participants. With such a default payout option, participants can make a positive election for a different form of payment if they decide that such an election would better meet their goals and circumstances.

This default option has a very important advantage for plan sponsors: protection from litigation. And this option can also appeal to retirees: It's supported by substantial research as a viable payout option when combined with optimizing Social Security benefits, compared to many other possible retirement income solutions.[3,4,5]

Since the RMD is required at age 70 (age 72 starting in 2021), this default option also incents and potentially engages pre-retirees to make positive elections that might better meet their goals and circumstances, such as starting retirement income at an earlier age.

Competing Perspectives on Payout Options

For the accumulation phase, it's extremely common to offer pooled investment funds to DC plan participants. There aren't any serious competitors to this method of delivering investment options to participants, and DC plans have decades of experience with pooled investment funds.

For the payout phase, however, there are competing perspectives on the best use of retirement savings. Insurance companies want to sell annuities, whereas investment firms want to sell solutions with invested assets. Each perspective has a compelling rationale that's supported by respected research.

It's not too hard to imagine a lawsuit brought by an aggressive attorney against an unfortunate plan sponsor who designates one of these payout options as the plan's default, with respected expert witnesses opining on either side of the issue. There is substantial and respected research that can support the viability of either annuities or investment solutions.

A One-Size-Fits-All Option Is Difficult in the Payout Phase

In the accumulation phase, few people would argue that saving more money is a bad thing, which helps justify auto enrollment and auto escalation. In addition, respected and established research supports the use of default investment options that can apply during the long investment horizon of workers accumulating savings for retirement. And now we have at least a decade of experience with auto enrollment, auto escalation, and default investment options, with apparent success.

However, designing a one-size-fits-all default retirement income option is much more complicated than designing defaults for the accumulation phase. Ideally, an optimal payout solution would consider a number of factors that can be unique to each pre-retiree, such as:

- the level of guaranteed income the participant might receive from Social Security and pension benefits,
- the resources of a participant's spouse, if applicable,
- whether the participant or spouse will work part time for a while,
- the level of basic and discretionary living expenses, and
- the participant's preferences for addressing investment, inflation, and longevity risk in retirement.

Once again, it's not hard to imagine a plan sponsor that implements a default retirement income option (whether an annuity or investment solution), then finds themselves involved with litigation where an expert witness "proves" the default wasn't appropriate for the specific retiree's circumstances.

A carefully designed retirement income menu can provide the tools that help pre-retirees use their DC accounts to customize a portfolio of retirement income that meets their unique goals and circumstances. With such a menu, retiring participants could allocate their savings among at least three distinct options, as follows:

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 rates or other withdrawal percentages, coupled with investing in 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. Such an annuity could be delivered through an IRA rollover to an annuity bidding platform or through an in-plan annuity.

This menu is designed to address the variety of goals and circumstances that retiring participants might have. The RMD default option described previously helps minimize the plan sponsor's legal exposure.

The retirement income menu takes advantage of a substantial body of research conducted by the Stanford Center on Longevity (SCL) and sponsored by the Society of Actuaries (SOA) on viable retirement income strategies.[3,4,5,6,7,8] This research demonstrates that one of the most efficient uses of retirement savings is to fund a Social Security bridge payment that enables older workers to maximize their Social Security benefits. This same research demonstrates the viability of using the RMD as a payout option, coupled with a fund that invests substantially in equities to help protect against inflation. Participants who desire more risk-protected retirement income can buy an annuity or invest in fixed-income investments offered by the plan.

Now let's turn our attention to an education and decision support process that can help plan participants use the tools in the retirement income menu to customize their retirement income strategy.

The Default Process: Guiding Participants to Make Informed Decisions

Plan sponsors could design and communicate a process for participants who apply for retirement and want to deploy their DC accounts. Here's the basic idea: If a participant wants to access their DC accounts, they're first defaulted into a guided education and decision process that helps them navigate the decisions they should make to deploy their accounts in retirement. These participants can always opt out of the process and make a positive election to deploy their accounts.

Such a default process wouldn't be too different from mandatory briefings that are prevalent in today's work environment, such as briefings on safety rules, sexual harassment, nondiscrimination, and other employer policies. The important difference is that a participant can opt out of the retirement decision process.

Because of the importance and complexity of their ultimate decisions, the retirement education and decision process might take a few sessions to complete. It could ask participants to check when they've completed a segment to show their progress toward completion. Given the high stakes of their decisions, such a process should be a good use of their time.

It's important that the education and design process isn't biased by compensation or fees that a financial firm, insurance company, or adviser might receive. The process should be supported by respected and substantial research.

The Process Starts with Education

The process would start with an overview of the risks that retiring participants face and should address through their retirement income portfolio. These risks include:

- the risk of living a long time (longevity risk)
- stock market crashes
- inflation
- cognitive decline and diminished ability to manage investments
- taxes
- political

The educational process would emphasize that there's no risk-free retirement income option. Even Social Security, which addresses more of the above risks than other retirement income generators, is subject to political risk (in theory, Social Security benefits could be reduced by the federal government in the future). Diversification is the classic strategy to protect against various risks in the accumulation phase, and for that reason, diversification of retirement income sources can be appropriate for the payout phase as well.

The process would alert pre-retirees to the information they should gather to make well-informed decisions, such as their expected Social Security benefits, any pension benefits they expect to receive, retirement savings account balances, financial resources of their spouse or partner, expected living expenses, etc.

The Retirement Income Planning Decision Tree

The next step is to guide participants through the decisions they need to make. Here's a rudimentary "decision tree" that illustrates the basic steps of such a process:

1. Select a target retirement age/date.
2. Do you anticipate working part time in retirement? If so, for how long, and how much annual income to you expect?
3. When do you want to start Social Security benefits? The process could include an online optimization analysis that's readily available.
4. If you decide to delay Social Security after you retire, how will you enable this delay? Through part-time work? By building a Social Security bridge fund?
5. Decide how much savings to set aside for either a Social Security bridge fund, an emergency fund, and any other adjustments, such as a travel fun bucket.
6. Do you want more guaranteed income to supplement Social Security? If so, buy enough annuity to make you feel comfortable. Possibly cover a substantial portion of basic living expenses with guaranteed sources of retirement income.
7. For remaining funds, determine withdrawal and investment strategies. Defaults can be QDIA + RMD, although the plan could offer other withdrawal strategies coupled with investment funds in the plan. Withdrawals before the age when the RMD applies would use the same methodology.
8. Does your retirement income cover your expected living expenses? If yes, you might be done!
9. If not, do you want to explore other retirement income generators or sources of income, such as deploying home equity? Can you examine how to reduce your living expenses?
10. If you're still short, you may need to rethink your target retirement age and start over at Step #1.

This list illustrates the basic process and steps. An actual application, whether an app or computer-guided process, could contain more steps and robust information.

A key part of the process would be convincing participants that it's well worth their time and effort. It would remind them of other significant life events that required a lot of time and attention, such as earning their basic education or learning new job skills. At this stage of their lives, this process is equally important!

While this process might be a lot of effort for plan sponsors, there are numerous reasons why a plan sponsor might want to help.[2, 9] For example, this process could help plan sponsors manage an aging workforce; it could also be promoted as a low-cost plan improvement.

Could this process be a lot of effort for pre-retirees? Yes! But the stakes are high—their financial security for perhaps one-fourth to one-third of their total lifespan. Most people value truthfulness and authenticity when they're facing important life decisions. We shouldn't take shortcuts or sugarcoat the seriousness of these decisions.

References

The SCL/SOA reports and essays identified below include the analyses that support the conclusions discussed in this essay and also address the implementation issues and refinements to the strategies described herein. The last reference listed is a consumer-friendly book designed to help middle-income pre-retirees and retirees understand and implement straightforward retirement income strategies.

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. *DC Plan Sponsors Can Improve Critical Retirement Income Planning*, by Steve Vernon, FSA. Second in the series "Research That Matters Today," Society of Actuaries, July 2020.
3. *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.
4. *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.
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. *How to "Pensionize" Any IRA or 401(k) Plan*, by Steve Vernon, FSA. Stanford Center on Longevity, March 2018.
7. *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.
8. *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.
9. *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.
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.

This essay has also been published by the Society of Actuaries.

STANFORD CENTER ON LONGEVITY