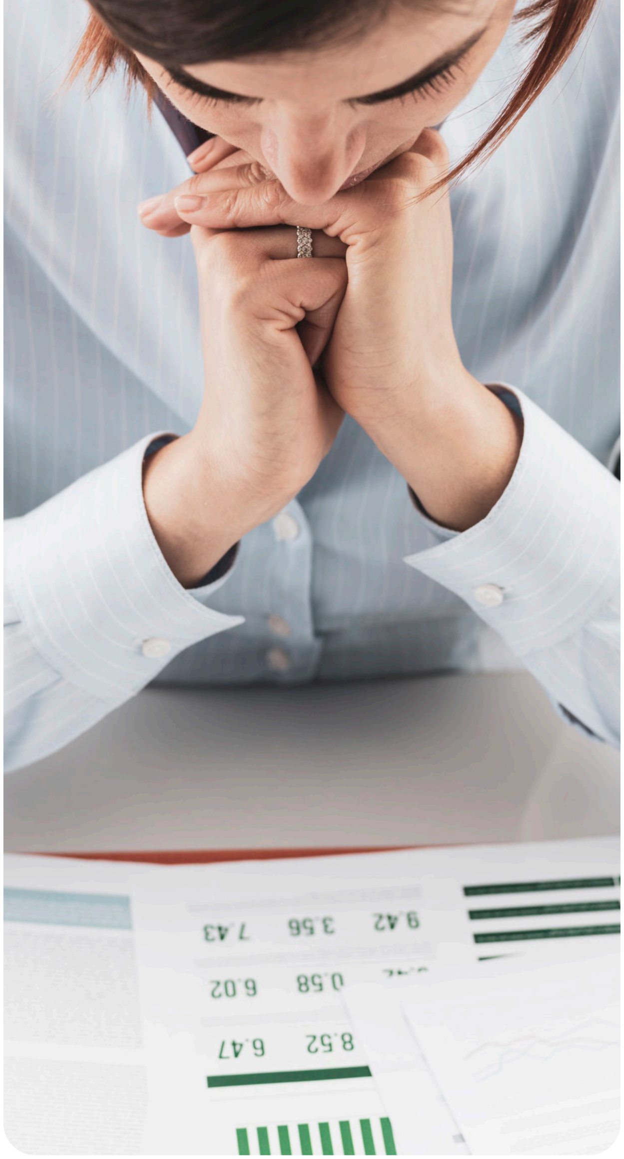
Retirement Income Statements that Educate and Don't Dangerously Mislead

By Steve Vernon, FSA, Research Scholar

Part Four of the series "Research That Matters Today"



An important challenge in the retirement industry is to help 401(k) plan participants understand the amount of retirement income that their savings can realistically generate in retirement. The underlying assumption is that most plan participants overestimate the value of their savings; if they really understood how much retirement income their savings might generate, they would increase their contributions.

To address this lack of awareness, many retirement professionals propose distributing statements to 401(k) participants that show estimates of the retirement income they might receive from their accounts. This retirement income statement would complement the familiar statement of account balances that participants currently receive. Presumably a retirement income statement would also help pre-retirees think in terms of retirement income instead of simply focusing on account balances, which might lead to more informed retirement decisions.

In December 2019, Congress responded to these proposals in the SECURE Act. This new law will require 401(k) plans to provide their participants with an estimate of the retirement income their accounts might generate. Future regulations will provide guidelines on how plan sponsors and administrators would prepare these statements.

While it's certainly a noble goal to help workers understand how their savings might convert into retirement income, the devil is in the details. If plan sponsors and administrators aren't careful with the design of retirement income statements, they could end up misleading pre-retirees and, in the process, enabling inappropriate decisions. This essay addresses some of the challenges with designing retirement income statements and suggests a design that could lead to more informed retirement income decisions by pre-retirees.

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Traps for the Unwary

A retirement income statement has the potential to create traps for the unwary. Here's the problem: The amount of estimated retirement income can vary substantially from the actual amount of retirement income plan participants might receive when they retire, depending on how they deploy their savings to generate income.

There are a few important reasons for this discrepancy. For example, when preparing retirement income estimates, 401(k) administrators often assume participants will buy a fixed annuity with their account balance. But most retirees don't spend all of their account balance on an annuity. Fixed annuities often generate more immediate income than most other retirement income generators. So, if participants don't buy annuities with their savings, they would actually receive lower amounts of retirement income compared to the estimates.

There are two more challenges that occur with these retirement income statements. The first involves the fact that in order to prepare these estimates, 401(k) administrators must make an assumption about the age when participants will retire. But this age could be different from participants' actual retirement age.

In addition, plan sponsors must make assumptions regarding the rate of return that participants' accounts will earn between the date of the statement and their assumed retirement date. Again, the actual amount earned could be very different from the assumed rate of return. The differences between these two assumptions and participants' actual experience mean the retirement income statements could miss the mark, sometimes significantly.

I've worked closely with older friends and relatives who've received retirement income statements from their 401(k) plans. They typically go right to "the number" and don't read all the fine print. And they often think their plan is like a pension plan and assume the estimated retirement income is the actual amount of retirement income they'll receive.

Sometimes a little bit of knowledge can be dangerous. Even if plan participants understand that they really don't have a traditional pension plan, they might interpret the retirement income estimate as a recommendation of the amount they can safely withdraw from their accounts during retirement. But if the retirement income statement is based on the assumption that plan participants will buy an annuity and they don't do that, one possible outcome is that many retirees will run out of money before they pass away.

Of course, when 401(k) administrators prepare retirement income statements, they protect themselves from liability by including paragraphs of fine print that describe how they prepared the statements. The fine print typically identifies the actuarial methodology, mortality tables and interest rate assumptions they used to prepare the retirement income statements. Almost no one other than an actuary would read and understand this fine print. Most plan participants don't even bother to try.

Here's the bottom line: Participants shouldn't blindly count on receiving the amount of estimated income they see in their retirement income statement. They need to look at more than just "the number" so they don't make uninformed financial decisions.

The fact is, there are many ways to generate retirement income from savings. Ideally, as participants approach retirement, they'll spend the time to do their homework and learn about various ways to convert their savings into retirement income. Then they'll make informed decisions about the best age at which to retire and how to best deploy their savings, recognizing their goals and preferences.

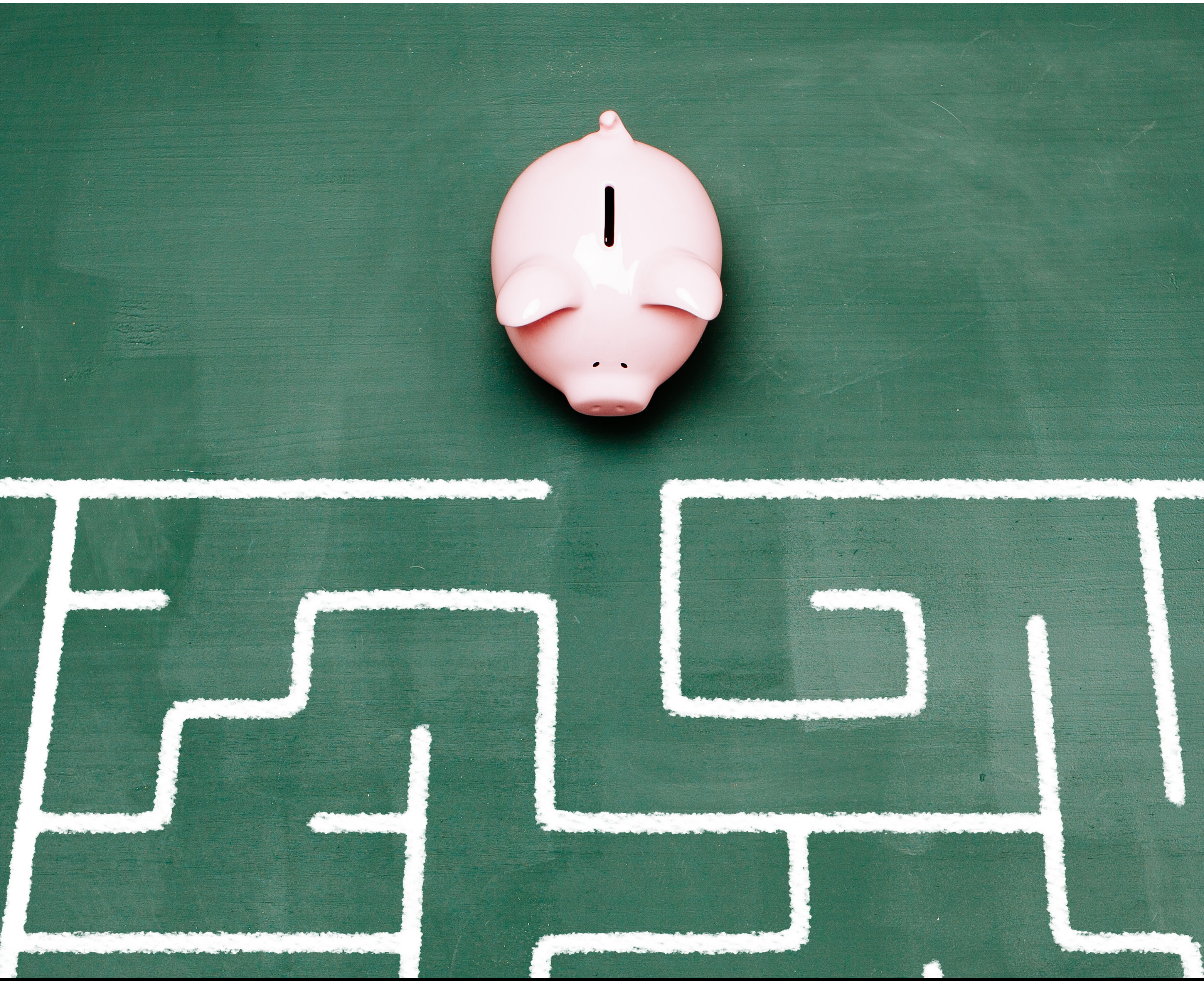
Yes, it will take more time for plan participants to undertake this learning. But given what's at stake—their financial security for 20 years or more—it's well worth their time.

Let's see how a retirement income statement could be designed to grab pre-retirees' attention and encourage them to investigate their options, while minimizing the confusing fine print.

A Retirement Income Statement That Educates

Let's assume that Jane Smith is a 50-year-old 401(k) plan participant with $100,000 in savings. The following is a sample two-page retirement income statement designed to educate pre-retirees on issues regarding converting their savings into income. It would also encourage them to learn more.

Please keep in mind that this sample just presents some basic concepts for communicating about retirement income. Plan administrators could embellish these statements beyond these basic ideas.



<u>Sample Retirement Income Statement: Page 1</u>

Jane: Don't Plan for Retirement Without Understanding This Critical Information

How much retirement income could your savings generate? Understanding possible answers to this critical question will help you make important retirement decisions, such as how much to save for retirement, when you can afford to retire, and how to deploy your savings in retirement. To help you learn more, this statement includes two estimates of the amount of retirement income that your savings might generate.

Jane, our records show that you've accumulated $100,000 in savings as of January 1, 2021, and that you're age 50 on that date. To prepare this estimate, we assumed that you would retire at age 65 and would still have $100,000 in savings to generate retirement income.

- If you buy an annuity, we estimate you'll receive **$458 per month**, guaranteed by an insurance company for the rest of your life.
- If you invest your savings and elect a monthly installment method, we estimate you'll receive **$260 per month** that could be paid indefinitely.

Your retirement income will be larger than these amounts if you continue to contribute to your account and if your savings grow with investment earnings. The above estimates don't include Social Security benefits, which would add to your total retirement income.

It's important that you understand how we prepared these estimates. Please see the section titled "Details about these estimates." Please keep reading to learn more about planning for income in your retirement.

There's a wide range of possible retirement income amounts you might receive

The reality is there are many viable ways to turn your 401(k) account into a stream of lifetime income when you retire. These different methods each have their pros and cons, and they each produce significantly different amounts of retirement income. That's why we prepared two estimates of your retirement income using different retirement income generators.

What are your next steps?

Jane, we strongly encourage you to learn more about different methods for generating retirement income from your savings. To help you, please see our online guide, Learn About Retirement Income Generators (RIGs). We also encourage you to use our online Retirement Income Modeler. With this tool, you can see how your retirement income might change due various decisions that you might make, as described on the next page. For example, you can see how future contributions and investment earnings could increase your retirement income.

It might take you some time to read these materials and use our modeling tools. However, it's a great use of your time. Your financial security in retirement depends on decisions you make, and these are serious decisions. You could live 20 years or more in retirement, so take the time you need to make informed decisions!

How could your eventual retirement income be different from these estimates?

Your actual retirement income could increase or decrease compared to these estimates, due to the following factors:

- Investment income that your accounts earn until you retire would increase the amount of retirement income you might receive. However, if your account loses money, you could receive less retirement income.
- Continuing to contribute to your accounts while you're working will increase the amount of retirement income you might receive. However, withdrawing or borrowing from your accounts before retirement could decrease the amount of retirement income you might receive.
- Retiring before age 65 would decrease the amount of retirement income you'd receive, since it would be paid for a longer period compared to retiring at age 65. On the other hand, retiring after age 65 could increase your retirement income.
- If you buy an annuity that continues payments to a spouse or partner after you die, your eventual retirement income could decrease.
- Selecting different methods to generate retirement income would generate different amounts of retirement income.

Details about these estimates

To estimate the annuity payment you might receive, we assumed you would buy an annuity called a "single premium immediate annuity," and is payable only for your life. We used annuity purchase rates that insurance companies were charging in the Fall of 2020 from the website ImmediateAnnuities.com. There are other types of annuities you could buy that might generate different amounts of retirement income.

With installment payments, there's no guarantee that the estimated payment amount will continue for the rest of your life. Your actual payments will depend on investment income your account earns throughout retirement, how much you withdraw during retirement, and how long you (and your spouse or partner, if applicable) might live.

To estimate the monthly amount of installment payment you might receive, we used the method the IRS uses to determine the required minimum distribution (RMD) that applies at age 72. While these rules don't apply to you at age 65, the IRS methodology is one of several reasonable installment methods you could use to generate retirement income from your savings. The RMD method starting at age 72 is the default form of payment under our 401(k) plan, if you don't make a positive election. There are several other reasonable installment payment methods that would generate different amounts of retirement income.

End of Sample Statement

Discussion and Conclusions

The reality of retirement planning in a defined contribution world is that plan participants assume the responsibility for making their retirement income last for life. This is a serious responsibility, and it doesn't make sense to take short cuts or sugarcoat the seriousness of this responsibility.

The main goal of the retirement income statement discussed in this essay is to encourage participants to learn more about their retirement planning decisions. It helps avoid the traps for the unwary mentioned in this essay by showing the range of possible retirement income amounts. There isn't any complicated fine print that describes actuarial methods and assumptions that only actuaries would understand.

This design also serves the original purpose for providing retirement income statements, by giving participants estimates of how much income their accounts could generate.

It would be a mistake simply to distribute retirement income statements without providing resources for participants to learn more. The retirement income statement described here should be part of a robust program to educate participants on the issues that come with generating income in retirement and, in particular, the importance of the age at which participants retire.[1] Such a program should include a basic primer on the features and pros and cons of different retirement income generators and an online retirement modeling tool. It would also show participants how they could learn about Social Security benefits and how to estimate these benefits.

Plan sponsors would deploy marketing and behavioral economics strategies to encourage plan participants to take the necessary time to learn more about their retirement decisions.

There are many good reasons why plan sponsors would benefit from providing this information to their participants, as discussed in Parts Two and Three of this series.[2,3]

There's a substantial body of research conducted by the Stanford Center on Longevity (SCL) and sponsored by the Society of Actuaries (SOA) on retirement income strategies.[4,5,6,7,8,9] Let's use this research to help plan participants make the best possible retirement income planning decisions in a defined contribution world.

References

The SCL/SOA essays and research reports identified below include the analyses that support the conclusions and strategies discussed in this essay. 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. *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.
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. *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.
6. *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.
7. *How to "Pensionize" Any IRA or 401(k) Plan*, by Steve Vernon, FSA. Stanford Center on Longevity, March 2018.
8. *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.
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.

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

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