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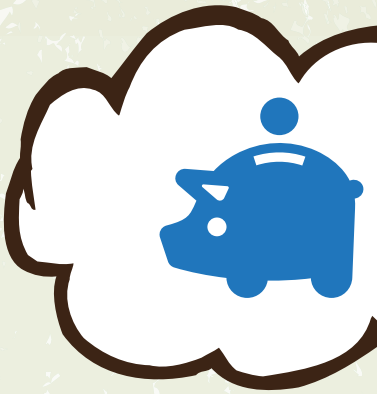
MAGAZINE

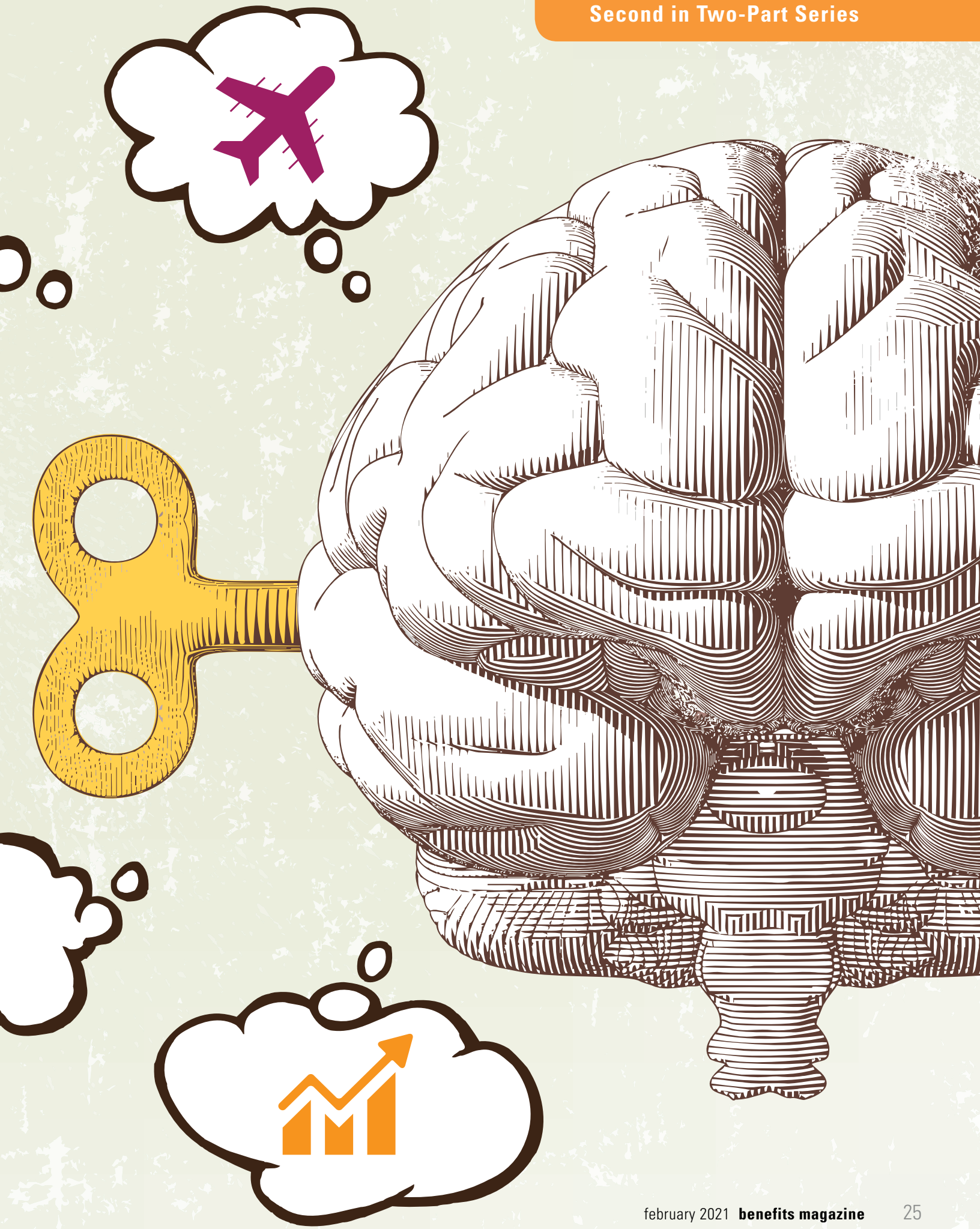
CRITICAL DECISIONS:

Helping DC Plan Participants Plan for Retirement Income

by | **Steve Vernon**



Preretirees face critical decisions when determining how to generate the most retirement income possible from their financial resources and how to make it last the rest of their lives. In this second article of a two-part series, the author shares how defined contribution (DC) plan sponsors can help their participants make critical decisions such as when to retire and how to deploy savings in DC plans to generate lifetime retirement income.



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

- 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 defined contribution (DC) plan sponsors help preretirees make effective decisions? How can ordinary workers retire in the DC world of 401(k), 403(b) and 457 plans?

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. Three of these reports identify and analyze a straightforward retirement income strategy that can work well for most middle-income preretirees and can be implemented in virtually any DC plan or individual retirement account (IRA). It's called the *Spend Safely in Retirement Strategy* or the *Spend Safely Strategy* for short.

The economic turmoil of 2020 reinforces the need for straightforward retirement income strategies that generate reliable income streams. This turmoil has left retirees and those nearing retirement concerned about their economic future and often confused about what to do next.

By offering the right resources, DC plan sponsors can help their plan participants to be informed and effective when making critical retirement planning decisions in uncertain times. Please see the January issue of *Benefits Magazine* for more details on the five most important retirement decisions for preretirees.

Introducing the Spend Safely in Retirement Strategy

The 2017 SCL/SOA report analyzed and compared 292 different retirement income strategies that use *stochastic forecasts* and *efficient frontiers,* which are analytical techniques that many large pension plans use to devise funding and investment strategies. The *Spend Safely Strategy* compared favorably to these 292 strategies, using eight different metrics described in the report. The most recent SCL/SOA report (2019) analyzes the *Spend Safely Strategy* in detail.

Preretirees take two steps to implement this strategy.

Step 1

In the first step, preretirees maximize expected lifetime 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.

Preretirees can use one of two possible ways to delay starting Social Security benefits:

1. If possible, work part-time to earn 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 start their Social Security benefits.

SCL/SOA research demonstrates that a Social Security bridge payment can generate more additional retirement income than other retirement income generators.

Step 2

Preretirees then implement a straightforward strategy to generate retirement income from savings to supplement Social Security benefits. To accomplish this goal, they should invest retirement savings in a low-cost balanced, target-date or stock index fund, which are commonly offered in DC plans. Then they can use the IRS required minimum distribution (RMD) rates to determine the amount to withdraw from savings each year. They can use the same RMD methodology to determine annual withdrawals before the age when the rules apply (which was increased from age 70 to 72 by recent legislation).

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. 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.
- Some retirees may want more guaranteed lifetime income than Social Security provides.
- Retirees can adjust the strategy to reflect income from working that

they might receive in the early years of their retirement.

- Retirees could adopt a strategy to spend additional money on travel and hobbies during their first years of retirement—while they are still vital and healthy—without jeopardizing their long-term financial security.
- Similarly, retirees could provide financial support to their adult children or donate to charities in a responsible way.
- Some retirees might want to adjust the strategy to reflect their health status.

Offering a Retirement Income Menu

A retirement income menu can help participants implement effective retirement income decisions.

DC plan sponsors and employers that want to help their preretirees and retirees generate retirement income often seek the one "perfect" retirement income strategy that can meet the needs of all their preretirees and retirees. However, the SCL/SOA research shows that there are no perfect solutions. Instead, this research demonstrates that there are a handful of viable, different solutions that, when considered together, could meet a variety of goals and needs that their older participants might have.

This conclusion should make sense since no DC savings plan offers just one investment fund that meets the investing needs of all plan participants. The vast majority of savings plans offer a menu of different funds to meet the varied needs and goals of their plan participants.

Similarly, DC plan sponsors can help preretirees and retirees by offering a basic retirement income menu in their plans that complements the familiar investment menu. With such a retirement income menu, participants who are nearing retirement 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. This option can fund a Social Security bridge payment that helps maximize lifetime guaranteed income from Social Security.
2. Monthly installment payments using the Internal Revenue Service (IRS) required minimum distribution (RMD) or other withdrawal strategies, coupled with a low-cost balanced, target-date or stock index fund. These payments are designed to be paid indefinitely. At any time, remaining funds could be redeployed to other retirement income generators.
3. An annuity to supplement Social Security benefits with additional guaranteed lifetime income. There are two ways a plan sponsor can deliver this option:

- Facilitate a transfer from the DC account to an online annuity bidding service through an IRA rollover.
- Implement in-plan annuities if the plan sponsor decides that feature would be advantageous to participants.

Such a retirement income menu would enable preretirees and retirees to implement the *Spend Safely Strategy* and many other viable retirement income strategies. This menu could also help older plan participants adopt the refinements and adjustments to personalize the strategy described earlier in this article.

A Default That Supports Effective Decisions

Autoenrollment features and default investment options have been successful in boosting participation in DC savings plans. Bolstered by this success, some DC plan sponsors are interested in designing a default payout option.

However, given the complexity and high stakes with retirement income decisions, there really isn't a one-size-fits-all retirement income solution that could possibly address the goals and circumstances of many preretirees and retirees. The best outcomes for plan participants usually occur when

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Steve Vernon. 2020. Rest-of-Life Communications.
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Ready or Not: Your Retirement Planning Guide, 47th Edition
International Foundation and Elizabeth M. McFadden. 2020.
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they learn about the issues associated with generating retirement income, analyze their options and make informed decisions.

As a result, plan sponsors might want to design a default retirement income solution that encourages engagement with their preretirees and retirees while providing liability protection for plan sponsors. One viable default solution that meets these two goals is to use the payout rates under the IRS RMD, coupled with the fund or funds most recently elected by the participant. If the participant hasn't made a positive investment election, the plan's qualified default investment alternative (QDIA) would apply.[1] Since the RMD rules require account holders to make withdrawals beginning at age 72, using the RMD default would encourage participants to make a positive election to deploy their accounts if they want their money before that age. In fact, the RMD rate is already the default payout option that is often embedded in the fine print of many DC plan documents.

The RMD default is the only retirement income solution that currently enjoys regulatory and legislative support. SCL/SOA research demonstrates that this default solution is a feasible strategy. One of the research reports discusses how the design of the retirement income menu and default payout option might mitigate any potential liability exposure a plan sponsor might have.

Participants Need Robust Communications Support

Given the complexity and high stakes of retirement income decisions, plan sponsors can also significantly help their participants by providing detailed communications materials about retirement income strategies and decisions. This material can help preretirees navigate their most critical retirement income decisions by clearly explaining how the retirement income menu supports decisions that meet their goals and circumstances. The basic idea is to provide communications and support materials that are just as robust as the communications materials offered by DC sponsors to explain the investment fund menu. While the target audiences for this communication material are preretirees and retirees, it should be made available to all plan participants to help them with their long-term planning.

A robust communications campaign could include a default decision process that helps older participants navigate the issues of retirement income decisions. Preretirees would be automatically defaulted into the process if they want their money from the DC plan. They could always have the freedom to opt out of the process and simply make a positive election to receive their account balance.

Such a decision process would discuss the pros and cons of these three basic retirement income strategies:

1. A Social Security bridge fund that helps optimize these benefits
2. Installment payments with invested assets
3. Annuities.

The decision process could then guide participants to implement retirement income elections in the DC plan that reflect their goals and circumstances.

Plan sponsors also could prepare and distribute retirement income statements that illustrate estimates of the amount of retirement income that participants' accounts could generate. The Setting Every Community Up for Retirement Enhancement (SECURE) Act requires DC plans to provide participants with an annual estimate of the lifetime annuity that could be purchased with their account balances. Plans will have to begin making these disclosures in 2022. While

takeaways

- Decisions that older workers must make, such as when to retire and how to generate reliable retirement income, are more complex and come with higher stakes than the savings and investing decisions these workers made throughout their working years.
- The economic turmoil of 2020 has left preretirees and retirees concerned about their economic future and reinforces the need for straightforward retirement income strategies that generate reliable income streams.
- Defined contribution (DC) plan sponsors may want to consider offering a retirement income menu that complements the familiar DC plan investment menu. Participants could allocate their savings among various retirement income options and implement these solutions within their plan by simply "checking the box."
- Such menus should include at least three options: (1) a fixed monthly installment payment for a specified period, (2) monthly installment payments using the Internal Revenue Service (IRS) required minimum distribution (RMD) or other withdrawal strategies, and (3) an annuity to supplement Social Security benefits.
- A robust communications campaign should be used to help preretirees navigate their retirement income decisions and explain the pros and cons of the basic retirement income strategies.

bio

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workers are accumulating savings, these statements can be effective at communicating retirement income concepts that help workers decide how much to save for retirement.

However, retirement income statements have the potential to mislead preretirees and retirees about the amount of income they might actually receive in retirement. Here's the problem: Retirement income statements are typically based on the assumption that participants will buy annuities with their entire account balances. This assumption can create two serious problems:

- Annuities usually produce the highest amount of initial retirement income compared with other retirement income generators. If participants elect other methods to generate retirement income, they will receive lower amounts of retirement income compared with the estimates shown in their retirement income statement. As a result, they might be misled about the appropriate age to retire or about the amount of money they might have to spend in retirement.
- If retirees don't buy an annuity but instead invest their accounts and withdraw the amounts shown on their retirement income statement, they run the risk of outliving their savings.

Retirement income statements are blunt instruments that can help workers decide how much to save for retirement throughout their working lives. However, the complexities of generating retirement income require more sophisticated and nuanced methods to communicate retirement income strategies to preretirees and retirees.

In Conclusion

The steps described in this article can help make the best use of the hard-earned money that participants and plan sponsors have contributed over the years. To help plan participants make critical retirement planning decisions in a DC world, DC plan sponsors should consider evolving their plans from *savings* plans to true *retirement* plans.

Note: This article draws from essays published by the Society of Actuaries in September 2020.

Endnote

1. A *qualified default investment alternative* (QDIA) is a fund used for automatic enrollment programs and in other situations where participants have the opportunity to direct the investment of assets in their defined contribution account but choose not to.

References and Resources

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.*

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