NAGDCA

RETIREMENT INCOME STRATEGIES OR RETIREMENT SAVINGS PLANS ARE NOT JUST ABOUT SAVING ANYMORE

INTRODUCTION

The traditional notion of defined contribution retirement savings plans in the public sector has been viewed as a voluntary savings plan to supplement the primary defined benefit pension plan income available to most public sector employees. More recently a variety of factors has increased the concerns that defined contribution plans should also focus on plan features that address distributing those accumulated assets as retirement income over time.

Retirement income has been and continues to be a focus of concern for policy-makers, plan sponsors, and plan participants in the public and private sector. Demographics highlight their concerns with a growing population of older Americans (both as a percentage of the population and in gross numbers); greater attention to public defined benefit plans as the primary source of guaranteed lifetime benefits; the continuing examination of the appropriate roles of defined contribution plans in the public sector; volatility in financial markets; and low rates of return on retirement investments.

The purpose of this paper is to provide plan sponsors and other interested parties with a broad overview of potential retirement income strategies, the considerations of prudent implementation, and general information regarding new and emerging retirement income oriented strategy. It is not intended to portray any particular strategy as superior to any other, but rather to highlight the trade-offs that plan sponsors should consider when reviewing options and provide a basic understanding of the differences that exist.

"Ensuring that employees have sufficient retirement income is one of the primary goals of public retirement programs."[1] Public sector defined contribution plans (457(b), 403(b), and grandfathered 401(k) plans) have provided public employers with a retirement savings program for their employees that was initially designed to supplement the defined benefit retirement plans that are prevalent in the public sector. Sanford and Franzel note that a 30-year public employee who receives a combined pension and Social Security benefit of 85% "would not need to purchase additional annuities with their savings." [2]

[1] The Evolving Role of Defined Contribution Plans in the Public Sector", Paula Sanford and Joshua M. Franzel, A joint research project of the Arthur N. Caple Foundation and the National Association of Government Defined Contribution Administrators by the Center for State and Local Government Excellence, September 2012. page 17
[2] Ibid. page 17

However, not all public employees are long-term or lifetime employees, meaning that many have not accumulated sufficient years of service credit to provide a high percentage pension benefit. Furthermore, not all public employees are eligible for Social Security. Many plan participants face a number of issues at retirement that have an impact on their financial security during retirement. "When individuals transition from asset accumulation to decumulation of retirement funds, they have numerous choices to consider and options to weigh"[3] Sanford and Franzel state. "Balancing the consumption and savings tradeoff is particularly important for employees with hybrid or core defined contribution plans when they begin to spend down their retirement savings."[4]

The challenge for government policy-makers, plan sponsors, and plan participants is to build the income resources necessary to maximize retirement income security and then to ensure that these resources are used wisely and in accordance with the wide range of objectives participants have for their accounts in retirement. The public employee population has certain advantages in this regard, as defined benefit plan arrangements have been the norm rather than the exception for state and local governments. Sanford and Franzel noted that "State and Local government defined benefit plans have historically offered a reliable and adequate level of retirement income."[5] However, state and local governments across the country are currently examining their defined benefit plans, particularly for newer employees. Some have questioned the funding levels of these plans. And instability in labor markets along with other secular trends (e.g., increasing retiree medical costs, etc.) mean that many government employees may be challenged to adequately fund their retirement income needs through the defined benefit plan alone.

Given this, defined contribution plans are taking on a greater role in the retirement income equation. This is why the discussion of retirement income strategies has grown in recent years. How to effectively address retirement income strategies in defined contribution plans is not a new one. Certain strategies are well-known and have been in use for some time, while others represent newer approaches. The retirement income strategy category is a broad one and incorporates a range of product and non-product tools.

EVALUATING POTENTIAL RETIREMENT INCOME STRATEGIES

Defined contribution plans are popular with plan participants because of their portability, flexibility, and the appeal of controlling a measurable pool of assets at retirement (participant control). Defined benefit plans are appealing to participants because, in their traditional form, they promise to provide a stream of retirement income that a participant cannot outlive (plan sponsor responsibility). As plan participants approach retirement, whether in volatile or more stable markets, many plan participants have sought a balance between income, security, and growth potential.

Upon separation from service, defined contribution plan participants have three fundamental choices:

[3] Ibid. page 18
[4] Ibid. page 18
[5] Ibid. page 3

- **Establish a Payment Stream** – withdraw assets for the purpose of creating a primary or supplemental income stream.
- **Initiate a Partial or Full Lump Sum Withdrawal** – withdraw assets in whole or in part for the purpose of creating a funding source for specific financial objectives.
- **Defer Distributions** – distributions from most defined contribution plans are not required until the year the participant turns age 70 ½ when Required Minimum Distributions begin.

Plan sponsors have a variety of product and non-product tools available as potential resources to the plan participants. Each of these tools, and the assembling of a range of tools, should be considered both in terms of their apparent functionality (do they appear to work in meeting a given set of objectives) but also their practical utility (are they used in the way they were intended).

Two important considerations should be kept in mind. First, a "one-size-fits-all" approach is probably not realistic. This is because different participants will have different objectives. While in general, plan sponsors may believe that plan participants may be well served by converting their retirement savings balances into retirement income streams, participants may have differing objectives.

In addition, a participant who has substantial other retirement income resources may view his or her account as a source for lifestyle enhancement purchases, or even as a resource to bequeath to heirs. For such a participant, the utility objective will be more important than other objectives. The same would be true for a participant with a small account balance who cannot use it as a meaningful long-term income source, but for whom the account may be a special resource for an emergency or major purchase.

Some participants may be facing conflicting goals that will need to be sorted out as part of his or her individual decision-making process. A participant may wish, for example, to have both lifetime income and the freedom to make periodic withdrawals. These goals may not necessarily be exclusive of one another, but balancing them out will require making tradeoffs. In designing retirement income strategies, plan sponsors should be mindful of how to best create a structure which allows participants to successfully navigate making these tradeoffs.

The following factors should be considered in evaluating various options:

- **Conversion** – Converting an account balance into a stream of income may appear to be an ideal objective for most plan participants. The risk for many participants is that they retire with a substantial account balance which might otherwise provide needed retirement income security, then undermine or squander that resource through periodic large withdrawals. However, participation in a defined benefit plan and/or Social Security may mitigate the need to convert plan assets to a retirement income stream.

- **Longevity** – Converting a balance to a retirement income stream is a beginning but not the end of an income strategy, because ideally the income stream will be commensurate with the participant's remaining lifespan. For example, there is a 58%

chance that one member of a married couple who are both healthy at age 65 will live to age 90 , and a 30% chance that one will live to age 95.[6] Additionally, as retirees live longer, inflation becomes a more serious risk to undermining the value of the income stream.

With 2.5% annual inflation, today's dollar loses over 50% of its purchasing power over 30 years. Given that one primary purpose of an income product is to ensure retirees don't outlive their money, addressing inflation sensitivities is a necessary way to ensure that purchasing power remains steady throughout retirement.

To address these uncertainties, a retirement income strategy can be evaluated based upon its ability to deliver a stream of real income during retirement over the participant's anticipated lifespan (and possibly the lifespan of any dependents, such as a spouse).

- **Risk Management** – Risk management involves the tailoring of a retirement income strategy to a participant's risk tolerance and investment objectives. This is no different than risk management for an active employee managing account balance accumulation, except to the degree that the participant's retirement income objectives may dictate more conservative investment strategies or other de-risking strategies to address sequencing of return risk associated with a decumulation phase. Once again, there is no "one-size-fits-all" approach to risk management.

  Participants who are less dependent on their defined contribution accounts may be comfortable with taking on more risk. Participants who are extremely dependent on their accounts may not be able to take on any risk. Therefore, in evaluating retirement income strategies it's important to ensure that the strategy (or range of strategies) provides for benefit flexibility for participants who have different relationships to risk.

- **Utility** – As mentioned previously, there is tremendous variation in the range of participant circumstances upon retirement. While plan sponsors may assume that many, if not most, plan participants may be best served by converting their defined contribution balances into retirement income streams, this will not be true of all plan participants. In addition, plan sponsors may feel the need to empower participants looking for lifetime income with full flexibility and control over their account value to address unexpected events like health status changes that may impact participants' objectives down the road. The plan sponsor may then wish to provide options which allow for participant flexibility. Non-product tools which allow participants to make changes to their distribution elections as needs and circumstances change over time are an important resource for this segment of the retired population.

[6] Annuity 2000 Basic Mortality Table, The Society of Actuaries.

- **Communication** – The responsibility placed upon plan participants in a defined contribution plan, i.e., decisions related to a proper deferral rate, investment choices, and asset allocations, during employment can be overwhelming. The responsibility to create a retirement income stream is an additional complexity and has tremendous ramifications. Therefore, it is important for plan sponsors to evaluate any product or service available in their plan against the benchmark of whether and to what degree participants will respond positively to the concept. If participants cannot be realistically expected to understand the option being presented to them, it's unrealistic to expect that they will be able to make appropriate decisions about those options. This is why plan sponsors should, in approaching the development of retirement income strategies, invest the time and effort to gauge the communications burden and effectiveness of individual strategies and the possibility of other strategies. Even if a strategy by itself can be understood, if it's part of a broader constellation that becomes overwhelming to participants, it may still become ineffective. Focus groups and surveys can be important tools of understanding how your participants experience the products or services under consideration.

- **Administration** – Plan sponsors should evaluate the administrative burdens placed on them to provide potential retirement income strategies in the same way that they evaluate administrative burdens for any other product or service associated with their plans. These potential burdens include those associated with procuring and executing contracts with service providers; communications; consulting expenses; required staffing resources; and ongoing oversight and monitoring. If the needs of the strategy are not commensurate with the resources available to administer it, it may not be appropriate to implement it. On the other hand, effective retirement income strategies may provide benefits for more effective workforce management. As employers identify retirement income strategies that meet the needs of their participants, they may see more predictability and stability within the workforce.

- **Portability** – Plan sponsors must also consider the ability of, and limitations on, transitioning a particular benefit as the plan and its service providers evolve over time. Non-product tools such as period payment streams provided through a third-party-administrator may be relatively easier to transfer from one administrator to another while product tools may create more challenges. Given this, the portability of any proposed strategy must be evaluated before it is adopted into the plan.

RETIREMENT INCOME STRATEGIES

Non-Product Strategies

Non-product options are typically authorized in the plan document and administered by the plan administrator. The following is a review of the primary non-product and product options available to plan sponsors as retirement income strategies:

- **Payments Fixed by Time Period** – Participants elect to receive benefits payments on an installment basis (e.g., monthly, quarterly, annually, etc.) for a period of time elected by the participant (e.g., 10, 20, 30 years). Payments are calculated by simply dividing the current account balance by the number of remaining payments. [7]

- **Payments Fixed by Amount** – Participants elect a specific dollar amount they would like distributed from their account on a regular installment basis (e.g. monthly, quarterly, annually, etc.). Payments continue until the account balance reduces to zero.

Non-product benefit payment option may offer advantages in terms of communications because the concepts and options are relatively easy for participants to understand. They are further distinguished by the generally greater flexibility they offer participants to start, stop, or modify elections. However, they may offer disadvantages in that the very simplicity and flexibility which can make them attractive to participants may also encourage participants to decumulate inefficiently, thereby undermining the value of the balance as a secure stream of retirement income.

Product Strategies

Annuities

Initially, there are two primary decisions when choosing an annuity: a) fixed or variable benefit payments; and b) immediate or deferred benefit payments. A fixed annuity's payment is constant and starts either immediately or, if a deferred annuity is chosen, at some agreed upon future time. Conversely, a variable annuity payment stream varies with market conditions and payments may start either immediately or at some point in the future. Plan sponsors and individuals considering the use of annuities can address market, longevity and inflation risks by choosing an appropriate mix of fixed and variable annuities.

Traditional Annuities

An annuity provides an on-going payment stream to an individual in exchange for a one time contribution amount. Income annuities can be any combination of immediate or deferred, fixed or variable, and for life or for a fixed period.

The use of annuities, like the use of all income products offered to public sector 457(b) defined contribution plan participants, is relatively low. In contrast, traditional annuity products are common in some markets such as in public higher education and 403(b) plans offered by K-12 schools.

The cost of traditional annuities varies widely depending on whether an institutionally priced group annuity or an individual retail product is being made available. Where individual retail products are involved, investors perceive these products to be more costly as the cost of individual retail annuities can range from an annual investment management fees of 1% to 2% and often including surrender

[7] A subset of this category is the Required Minimum Distribution, a distribution mandate required of defined contribution plan arrangements under the Internal Revenue Code. Required minimum distribution is the amount required to be distributed to a participant once that participant has reached the age of 70 ½ and has severed employment. Amounts are distributed over the participant's life expectancy. The annual distribution amount is recalculated each year based on the existing account balance and revised life expectancy as set forth by the Federal government.

(or redemption) charges of 3% or more. Institutional annuities can leverage a larger group to potentially negotiate lower investment management or redemption fees. A participant will face additional decisions when choosing an annuity such as the selection of a single life, joint life, period certain, COLA adjusted, CPI adjusted benefits payment. These additional decision points can increase the complexity often resulting in the participant choosing nothing. Another reason affecting annuity selection is behavioral. When an individual purchases an annuity at retirement, they give up a relatively large sum of money "today" to receive a smaller stream of periodic income "tomorrow." There is an initial loss of financial flexibility, along with the perceived loss of value if the participant were to die early. While immediate annuities do offer a key benefit of steady income, the above factors may represent hurdles for those contemplating purchasing one.

Potential alternatives include group annuity products which can greatly reduce the price barrier. Participant counseling may also be effective in addressing the perception or impact of "all or nothing" annuitization as well as any perceived or actual loss of value if the participant were to die early. Since most public sector employees have access to a defined benefit plan and Social Security, they may only be considering annuitizing a portion of their accumulated assets in order to meet their retirement income needs. This allows the participant to retain access to the rest of their accumulated assets.

Where annuity products are commonly used, participants with Social Security benefits on average annuitize only about 25% to 35% of their plan assets. Withdrawals from the remaining balance can be managed to make up for temporary reductions in income due to poor market performance, or to satisfy one-time unanticipated needs.

Annuity Investments

In addition to participants purchasing a standalone annuity product, an alternate method of acquiring steady income is by embedding a deferred fixed annuity product into a plan's investment options. There are different types of deferred or fixed annuity products with different approaches to crediting interest and accumulating the future retirement income payments. Plan sponsors will need to evaluate which kind of fixed annuity product best meets the needs and objectives of their plans from a fiduciary perspective.

Target date funds are increasingly including imbedded deferred annuity features as well. Offering an annuity product in the target date package may mitigate fee concerns by offering institutional pricing, facilitating decision-making during the accumulation phase, and most importantly, by continuing to permit a lump sum withdrawal at retirement.

A target date fund with deferred fixed annuities may not have an allocation to traditional fixed income asset classes but instead has an allocation to deferred fixed annuities, with the annuity benefit becoming available when a participant retires. One key benefit of this option is that it looks like today's target date funds with a diversified underlying portfolio. However, since it is an annuity investment, its value is shown in lifetime income as well as asset accumulation. As the accumulation increases, so does the retirement income benefit.

There are a number of different features that can be incorporated into an annuity

option in order to be more responsive to participant needs:

- **Inflation Protection**: A cost of living adjustment can be embedded within an annuity option; this helps to maintain purchasing power throughout retirement.

- **Embedding Annuity within Target Date Fund**: Individual retail annuities can be expensive because of on-going investment management cost and potential surrender charges should an individual no longer wish to keep their annuity benefits. A target date fund with an embedded annuity should have no surrender charges; in fact, the target date fund with an annuity option should be treated exactly the same as other investment options in the plan lineup when it comes to moving from one plan option to another. Additionally, during accumulation, these annuities should be unallocated (that is, they are not tied to any one individual but instead are part of a group of participants), thus allowing the insurance company to incur lower administrative expenses, and as a result, the annuity itself should be less expensive. In addition, embedding the deferred fixed annuity within a target date fund means the participant is provided both an income floor as well as liquid pool of growth assets, invested in equities or otherwise. However, the plan sponsor should understand that an unallocated annuity may be liquid to the participant but not to the plan and there may be restrictions should the plan desire to move away from this product.

- **Broader Choices**: During working years, communicating the income benefits of a deferred fixed annuity is simplest when choosing one particular type of annuity (whether single life, period certain or something else). The goal is simply to generate an income floor. At age 65, however, it is important to provide choice to the participant. Not all participants will want the exact same annuity in retirement; offering a number of actuarially equivalent options post-retirement makes annuities a more compelling option.

Guaranteed Minimum Withdrawal Benefit (GMWB)

GMWB options are a category of newer lifetime income strategies gaining increasing popularity because it combines the flexibility and control over account value (like that of non-product strategies) with lifetime income (like that of more traditional annuities). The GMWB offers a guarantee of retirement income for life, but also provides exposure to equities and downside income protection along with withdrawal flexibility. Institutionally priced GMWB strategies address many of the participant concerns of more traditional guaranteed income strategies, including allowing a participant to fully access their market value at any time for special needs (including passing along the full market value to heirs upon the death of that participant).

How GMWB Strategies Work

A GMWB brings together an asset allocation strategy, like a target date fund, with an income guarantee and participants can get in and out of the option at market value at any time. The income guarantee generates an "income base," which is the

value of the participant's accumulated retirement assets at the time of activation, likely five to ten years before retirement. This activation of an income guarantee can either happen automatically or can be an affirmative investment election of the participant.

While GMWB vehicles differ among providers, generally all offer similar features that can make them useful as a retirement income strategy including:

- **A guaranteed lifetime retirement income based on accumulated assets.**

  A GMWB enables participants to lock in a guaranteed level of lifetime retirement income several years prior to retirement. Once the income guarantee is activated, lifetime income is established at a pre-specified percentage of the income base, based on the participant's age when the participant begins taking benefits. The income base and lifetime income benefits cannot decline due to market performance, which protects participants from a market value decline after the guarantee is activated, as long as participants adhere to the contractual requirements of the GMWB, including not taking income beyond the agreed upon percentage of the income base. If the income guarantee is activated prior to retirement, the participant is protected from fluctuations in market value when they seek to retire and begin taking retirement benefits.

- **Step-up of income base due to market appreciation before or during retirement.**

  The income base can be stepped-up when there is market appreciation after activation and prior to retirement. For example, a "step-up" could occur if markets increased when measured on a year-over-year basis. However, the income base will never decrease due to negative market performance. The income base is also stepped-up by additional contributions to the account. If the markets appreciate during retirement, the income base, and subsequently guaranteed retirement income, can also be stepped-up to a higher level. Once stepped up, the income base will never decline solely on account of market performance.

- **Optional spousal benefits.**

  The income guarantee enables a retiree to annually withdraw a certain guaranteed amount, expressed as a percentage of the income base (e.g., 5%), for life. If desired, the participant can choose payments over the combined lifetime of the participant and the participant's spouse (for a reduced payout percentage). As long as the participant takes no action to reduce the income base, the participant has a steady income stream regardless of how the markets perform or how long the participant or the spouse lives if the spousal option is chosen.

- **Flexibility and control over account value.**

  Unlike traditional annuity options, GMWB strategies provide the participant full access to the market value of the account at all times. If unforeseen situations arise

such as the need for emergency funds or healthcare expenses, the participant typically has full access to the market value of the GMWB account. However, it should be noted that withdrawals could result in a reduction of the income base and subsequently lower retirement income. Upon the death of the participant, any remaining market value in the GMWB is available to the participant's beneficiaries.

As with annuity products, one of the perceived drawbacks of GMWBs is their portability – what happens to the income base if the record keeper changes or if the income provider no longer has capacity or becomes uncompetitive. It is also important for the plan sponsor to understand the cost structure of a GMWB product.

GMWB product costs can vary depending upon the value of the benefit guarantee. Unlike that of more traditional annuity, GMWBs guarantee fees are explicitly stated and typically range from 100 to 125 bps for an institutionally-designed product.

Managed Payouts

A third retirement income strategy option is the managed payout. A managed payout may come in the form of a diversified fund, an investment advisory service (or managed account), or via a participant's active engagement of taking a percentage of the remaining account balance out of his or her account each year.
A managed payout is not guaranteed by an insurance company to protect against market or longevity risk, but rather is a managed fund designed to provide a predictable annual retirement income stream. Though these funds are potentially diversified across a number of asset classes, the principal dollar amount will likely change on an annual basis and go either up or down. There is no guarantee of the payment amount for any one year, as the amount can change based on market performance. The assets inside a managed payout fund are liquid, so a participant can generally access their principal at any time, allowing a participant to pay for a one time expense, for health care, or other immediate needs, or to leave as a bequest to beneficiaries.

The managed payout percentage is set once a year, usually on January 1st, and is based off of a percentage of the fund's holdings as of that date. The participant usually can select from a number of different payout percentages based on whether the participant is looking for a high payout for a shorter time period or a lower payout for a longer time period. The strategies are crafted with differing risk and return targets to try and meet the participant's needs.

FIDUCIARY CONSIDERATIONS

This section focuses on many of the important issues plan sponsors and plan participants must examine in order to take appropriate steps to assure their retirement income adequacy. Some of those issues pose immediate concerns, particularly for those who are near or in retirement. Other issues present the opportunity for longer-range planning and options.

Selection and monitoring of retirement income strategies

Any time a defined contribution plan sponsor seeks to add a retirement income strategy to a plan, it must do so in a way that is consistent with a whole range of legal, regulatory, and fiduciary requirements that are different than the more familiar world of selecting and monitoring a menu of investment options.

The first step in the process is to know the legal environment for your particular plan. Fundamentally, plan sponsors need to know the laws and legal documents that authorize, create, and govern their plan and what, if anything, those laws and documents tell the plan sponsor about whether and how retirement income strategies should or may be provided.

The first question is: what do the state and local laws and the plan and trust documents say about providing lifetime income to the plan participants? Do these laws and legal documents mandate, limit, or prohibit the use of retirement income strategies?

If the governing legal documents for the plan explicitly state that a retirement income product or feature must be provided, then the addition of a retirement income strategy to the plan offerings must be undertaken using a fiduciary process, including prudence. It is more likely, however, that the legal language may be ambiguous or silent on the question. If this is the case, it may then be beneficial to obtain good legal counsel to assist in the decision making process.

Some state and local laws have so-called "any willing provider" rules that may affect or limit the kinds of retirement income products that can be made available through the plan. It may be necessary for these governing legal documents to be amended in some cases.

Know the fiduciary standards that apply to you

Fiduciary standards for governmental plans will vary from state to state, but typically will be some form of the traditional prudent man, prudent person, or prudent expert fiduciary standards that exist.

Once the fiduciary framework is understood, the plan sponsor can work with its legal counsel, and possibly a fiduciary consultant, to create a due diligence process to help evaluate options and document the process.

The Department of Labor has spent a fair amount of time on ERISA fiduciary standards, and even though federal ERISA fiduciary rules for the selection and monitoring of annuity products do not apply to government plans, that guidance will likely prove to be very useful to public plan sponsors in selecting retirement income strategies and providers.

The ERISA safe harbor regulation protects fiduciaries when selecting either an immediate or deferred annuity product. The plan sponsor needs to conduct and document the following steps to be protected by this safe harbor:

- Conduct an objective, thorough, and analytical search when selecting providers from which to purchase annuities. If necessary, the plan fiduciaries should consult with appropriate experts.
- Consider information sufficient to assess the ability of the insurer to make all future payments under the product.
- Consider the cost (including fees and commissions) of the product in relation to the benefits and administrative services to be provided.
- Conclude that, <u>at the time of the selection</u>, the insurer is financially able to make all future payments under the contract and its cost is reasonable in relation to the benefits and services to be provided under the contract.

The phrase "at the time of the selection" of the annuity provider can apply to both:

- The time that the annuity provider and contract are selected for immediate distribution of benefits to a specific participant or beneficiary, and
- The time that the annuity provider is selected to provide annuity contracts at future dates to participants or beneficiaries (e.g., deferred annuities).

The fiduciary must monitor the continuing appropriateness of the annuity provider in this situation.

In-plan vs. out-of-plan responsibilities

Significant fiduciary obligations regarding the offering of a retirement income strategy occur when it is provided "in the plan." A strategy is provided inside a plan when the product or strategy is held as a plan asset, or the sponsor exercises control or discretion over it (i.e., the plan has technical ownership of the product or offers the product as a plan service). Just like a plan that owns a separate account and makes it available to participants, a plan that selects a retirement income product for the use of its participants has an "in plan" strategy. The plan sponsor assumes fiduciary duties when the retirement income product is a plan asset and is thus responsible for exercising discretion and control over the strategy and how it is offered in a prudent manner.

Generally, there is less fiduciary responsibility relating to "out-of-plan" strategies. For example, an annuity exists outside the plan if a plan allows participants to roll their money out to an IRA and the participant then buys a retirement income strategies product that point.

There are instances where a service could be considered as provided in the plan, while the actual retirement income product could be considered an out-of-plan strategy. A so-called "annuity shopping service" would be an example of this. An annuity shopping service is generally a third party that will help participants, for a fee, shop the retail annuity market to find a suitable retirement income strategy.

The plan sponsor would act as a fiduciary because it would exercise discretion in the selection of the service provider and retain limited oversight of the service provider during the period that the service is offered. The selection process must be done through a careful and deliberative process with a focus on the methodology and fees that may be received by the annuity shopping service provider from plan participants and the annuity products recommended by the service provider. The plan sponsor would also be responsible for monitoring the shopping service to ensure that the fees are reasonable and in accordance with any agreement between the services and the plan sponsor and that there are no conflicts of interest.

The plan sponsor could take the position that since the retirement income product purchased through the annuity shopping service is not held by the plan, it is not an in-plan product and thus is subject to less fiduciary discretion or resulting obligation.

A decision not to offer a retirement income strategy will not generally create a fiduciary situation unless that is contrary to applicable law or the plan documents.

In summary, fiduciary obligations generally do arise when the retirement income strategy is offered to participants. With respect to an in-plan strategy, when a plan

fiduciary exercises discretion or control over the strategy, the responsibility is great. However, out-of-plan strategies do not generally create the same level of fiduciary duties. It is important to have good legal counsel help navigate these sometimes blurry lines.

Issues facing plan sponsors in deciding which distribution options to provide

Plan sponsors can make the process of meeting their fiduciary responsibilities easier by developing concrete steps for the selection and monitoring of retirement income strategies within the plan. A good starting place is to consider the specific needs a retirement income offering seeks to address (i.e., systematic withdrawals, advanced life deferred annuities, sometimes referred to as longevity insurance, or an annuity that begins later in life, e.g. age 80 or 85, etc.).

An immediate annuity may make sense if the objective of the plan sponsor is to provide a supplement to a defined benefit program. However, if the primary objective of the sponsor is to provide a strategy which would prevent participants from outliving their assets, an advanced life deferred annuity may be the best choice. Through identification of the 'outcome-based' objectives of the plan and the role that the retirement income option is designed to play in the participant's strategy, clear selection and monitoring criteria can be determined.

Ability to understand the product and options within a product

In order to determine whether retirement income products are appropriate for a specific plan, the plan sponsors should consider the following:

- How important is it to offer a retirement income product?
- What value do participants place on retirement income products?
- Is it most appropriate to offer a retirement income option as an in-plan or out-of-plan strategy?

It is important to compare the amount of retirement income the product is providing for a set amount of contribution. One product might provide $70 per month for life for every $10,000 of premium and another may provide $60 per month. $70 per month is better, but it must be weighed against other factors including the financial strength of the company making the $70 promise. This is a balancing decision.

The key issues with offering retirement income products are: the terms of the investment and the ability of the issuer to fulfill those terms. In addition to evaluating the right product for a plan, plan sponsors should evaluate how comfortable they would be with offering retirement income products from a fiduciary standpoint.

Determining a "good fit"

Part of an effective due diligence process includes making sure that the products being considered are a good "fit" to meet the objectives of the plan. Following is a list of potential criteria against which to evaluate each of the products:

- How well does the product perform in maximizing retirement income?
- How portable is the product if the participant leaves employment or if the plan sponsor wants to terminate the relationship with the insurance company?

- Are the fees and costs reasonable and competitive and transparent?
- What are the inflation protection features and survivor benefit features?

This is not an exhaustive list and the decision may be made that some features are more important than others, but it is essential to know what you want the strategy to do and then seek strategies that fit, rather than trying to fit a square product into a round plan.

Monitoring the effectiveness of objectives

The plan sponsor should be able and prepared to monitor the retirement income product it is offering to participants. Creating measures in advance, such as developing watch status criteria and actions or pre-planning for a severe erosion of provider creditworthiness, are prudent fiduciary steps to take and will help to prevent 'knee jerk' reactions when issues arise. The plan sponsor should also periodically gauge the marketplace to validate that the fees, purchase rates, etc. of the retirement income strategy continue to be competitive. Finally, the plan sponsor should be able to measure how participants of varying income ranges are using the income strategy (for example, are lower-income participants more or less likely to use a particular type of strategy and why).

Portability

Two distinct aspects of portability must be examined. The first is portability from the plan sponsor's perspective, and the second is portability from the perspective of a participant who has entered into a retirement income contract with a particular provider.

One of the benefits of offering a retirement income strategy such as a systematic withdrawal or, to a somewhat lesser extent, a guaranteed minimum withdrawal benefit, is increased portability. Generally, there is very little portability (or liquidity) of an annuity by a participant, unless significant fees are incurred. In this regard, it is incumbent upon the plan sponsor to educate the participant as to the terms of the retirement income product and to make good faith efforts to educate potential purchasers in advance of finalizing such a transaction of any negative consequences of attempting to liquidate the product after purchase.

From a plan sponsor perspective, portability issues should be thoroughly examined prior to implementing any retirement income product. Addressing in advance a scenario of switching to an alternative provider, or eliminating the retirement income strategy outright, is necessary, as is discussing what steps would be taken in such scenarios.

Selection and monitoring of provider

A selection criterion can be applied only after identifying which needs of the plan and participants should be addressed by the retirement income strategy(ies). An emphasis on credit quality and fees of product providers will be paramount if an in-plan annuity is desired. With regard to the in-plan strategy, the benefits of reduced participant costs and increased control of offering an in-plan strategy do not come without heightened fiduciary responsibilities.

It is also important to note that these retirement income alternatives are not mutually exclusive. It may make the most sense, when looking at the plan holistically, to offer certain features in conjunction, such as a systematic withdrawal program and an advanced life deferred annuity. By carefully

determining the intent of the retirement strategy being offered, the fiduciary responsibility to select and monitor those implementing these strategies will become more defined and easier to adhere to.

Know your insurance and securities law environment

Retirement income products that provide guaranteed income involve insurance products and insurance companies that may also be considered securities in some cases. Each of the 50 states has regulatory authority over annuity or guaranteed minimum withdrawal benefit products distributed in their borders. There may be distribution and suitability guidelines that must be complied with. In some states, there is an extra layer of consumer protection guidelines, e.g., those that apply to the sale of such products to senior citizens. The states also regulate the life insurance companies by setting reserve and other financial requirements and standards.

All 50 states, the District of Columbia, and Puerto Rico have guaranty associations that protect policyholders in the event that an insurance company becomes insolvent. State guaranty associations are created and governed under state law, and thus there is some variation among states in the operation of their respective guaranty associations; most guaranty associations cover up to at least $100,000 in present value for annuity benefits.

Know the financial strength of the provider to meet its obligations

Retirement income strategies have various levels of promises being made by the insurer, and a fiduciary must be able to reasonably and objectively conclude that the insurer has the financial strength to meet its benefit obligations now and in the future for your participants. There are number of factors that help give you the information you need, including:

- A history of the insurer successfully providing and paying the promised benefits.
- The financial strength of the insurer in terms of capitalization, surplus, and contingency reserves.
- Credit ratings are another tool by which financial strength of the provider can be assessed. Generally, higher ratings mean greater financial strength. Financial strength of an insurer can be assessed by credit ratings issued by companies such as Fitch, Moody's, Standard & Poor's, and Best's.
- Flexibility of contract terms: the easier it is to get out of a contract, the better generally, but that must be weighed against the cost of that flexibility. Sometimes it costs a lot of money to get more liberal contract exit terms and that needs to be weighed against other objectives.
- The scope of additional protections that may exist through state guaranty association.

Risk-Based Capital positions are another measuring factor. Risk-based Capital (**RBC**) is a National Association of Insurance Commissioners (NAIC) standard to identify a desired amount of capital that a company should hold to protect customers against adverse developments. The highest crediting ratings, AA and AAA ratings, generally require risk-based capital of at least 300%. Higher ratings are definitely better at any time and most particularly during financially turbulent times.

Also, public financial reports of a provider can be used to identify the amount of capitalization of a company and their contingency reserves. Fees for guaranteed products can be complex, which makes it important that your assessment includes identifying any commissions, surrender fees, front end and back end load charges, and mortality and expense fees.

The fee structure of many retirement income products is imbedded in the insurer's general account, and there is something called the "interest rate spread," which is the difference between what the insurer thinks it can earn on the assets of the product and what it credits back to participants. That "spread" may be small or large but it is important to work with an expert to help you assess product pricing.

PARTICIPANT COMMUNICATIONS

Determining Participant Needs

In order to properly manage a plan, plan sponsors need to understand the purpose of their defined contribution plan and what participants expect from it. The potential for asset growth, downside protection, ready access to assets and flexibility in contributions are generally viewed as the purpose and goals of most defined contribution plans. However, recent studies and surveys have indicated that many plan participants above all want income that they cannot outlive. A survey conducted by the Insured Retirement Institute (IRI)[8] found that:

- Nine out of ten participants in defined contribution retirement plans seek guaranteed monthly income.
- 89% indicated that they would be in favor of this type of option and that plan sponsors should communicate with participants on the benefits of this type of investment.
- A majority of plan participants showed interest in having retirement income option information available through a retirement statement or a plan provider website.

There is a dichotomy, however, between preferences expressed by participants and their actual actions. A 2009 survey of 401(k) plans conducted by Hewitt Associates found that "only 7% of employers offered annuities within the plan while another 2% report planning to add this feature in the next year."[9] An earlier Hewitt survey found that "Only 6% of participants in 401(k) plans offering annuities as distribution options elect them upon termination."[10]

Plan sponsor communications

The plan sponsor should initially address the need for retirement income within the context of increasing longevity and market volatility. The potential impact of these two factors must be fully understood by the plan sponsors in order to make informed and beneficial decisions for participants who will rely on defined contribution plan assets for a material portion of their retirement income.

[8] Retirement Income Products, Institutional Retirement Income Council; Volume 4 Number 1, 2012.
[9] Trends and Experiences in 401(k) Plans Survey. Hewitt Associates, 2010, page 6
[10] Trends and Experiences in 401(k) Plans Survey. Hewitt Associates, 2005

In concert with and in addition to the factors cited earlier in this paper, it is important that plan sponsors consider the following factors when evaluating potential retirement products:

- Liquidity - understanding liquidity options at or prior to retirement.
- Withdrawal rates – the plan sponsor should be knowledgeable of the benefit payment types and structures that define the withdrawal rate.
- The current expenses related to the product and the ability of the provider to increase fees.
- Investment selection – the plan sponsor should determine that the investment options are appropriate and cost effective.
- Simplicity - the ease of understanding by participants.
- Safeguards – understand the benefits of a protected accumulation strategy.
- Portability – the ability of the plan sponsor to change providers or participants to move to another retirement income product.

Participant communications

Financial decisions required by participants at or nearing retirement can be daunting. Participants possess varying levels of financial knowledge, vastly different needs, different asset bases for their retirement and many unknowns both inside and outside the plan. Those unknowns include longevity, healthcare, the needs for major purchases and unexpected expenses. An individual's desired standard of living and retirement goals are more easily known and can be adjusted to meet retirement income realities.

A major hurdle is also finding a suitable balance between maintaining control over accumulated assets versus the desire for guaranteed income payments. Plan participants may have saved for many years and accumulated a significant account balance. Relinquishing control over those assets for a promise of a lifetime income is not an easy decision.

Many participants may have a strong desire to leave bequests to their beneficiaries. This desire must also be considered in an employee's decision-making process.

Thus, as retirement income strategies evolve, plan providers must develop education programs for plan sponsors and their participants that (1) address the varying needs of participants, (2) simplify the decision-making process, and (3) are clear in the terms of the retirement income product, including the possibility that any decision may be irrevocable.

There is a movement by some plan sponsors and plan providers to create awareness among participants in the retirement accumulation phase about retirement income and whether they are saving adequately to provide for it. One way to raise awareness is to provide lifetime income illustrations on participant statements and in educational materials. Using a number of assumptions, such as investment performance, retirement age, future contributions and life expectancy, these projections estimate the amount of lifetime income that could be generated by plan balances in retirement.

Regardless of the method of communication, education programs for participants moving from asset accumulation to an income distribution phase can be more effective by posing questions to

elicit a discussion of retirement needs. Participants may then be assigned to situational categories based on their responses, allowing suggested strategies applicable to the assigned category and helping the participant implement a course of action.