MERCER

SECURING RETIREMENT OUTCOMES

ARTICLE TWO IN A MERCER AND STANFORD CENTER ON LONGEVITY SERIES

HOW TO INCREASE YOUR EMPLOYEES' RETIREMENT INCOME

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Most 401(k) and defined contribution (DC) retirement plans pay employees a lump sum at retirement and send them out into the retail financial world to figure out on their own how best to generate a reliable, lifetime retirement income. When they have to rely on their own ability to generate retirement income, many withdraw amounts that are too high and thus exhaust their retirement savings prematurely.

Others may withdraw low amounts out of fear of exhausting savings, forcing financial cutbacks that may not be necessary. However, there is a better solution, and plan sponsors can play an important role in it.

Plan sponsors are in a unique position to offer their retiring employees Retirement Income Generators (RIGs). RIGs take advantage of institutional pricing rather than retail-based approaches, which tend to be higher-priced, and have the potential to boost workers' retirement income by 5% to 20% - or more![1]

In our review, we have drawn heavily on The Next Evolution in Defined Contribution Retirement Plan Design[1], a recent report from the Stanford Center on Longevity (SCL) and the Society of Actuaries (SOA).

INSTITUTIONAL PRICING HAS THE POTENTIAL TO BOOST WORKERS' RETIREMENT INCOME BY 5% TO 20% - OR MORE[1]

[1]Stanford Center on Longevity and Society of Actuaries. The Next Evolution in Defined Contribution Retirement Plan Design (2013). Available at: http://www.soa.org/Files/Research/Projects/research-2013-next-evol-dc-design.pdf.

THIS ARTICLE WILL INVESTIGATE THREE COMMON METHODS FOR GENERATING POSTRETIREMENT INCOME

SYSTEMATIC WITHDRAWALS

IMMEDIATE ANNUITIES

HYBRID PRODUCTS

SYSTEMATIC WITHDRAWALS

Systematic withdrawals are one way to generate retirement income from DC accounts. In this case, employees' savings remain invested in the employer's DC plan, and they elect to use an installment payment feature to generate periodic income payments.

The withdrawal amounts are usually set with the expectation that the payments will last for life, but there's no guarantee of that if employees outlive their life expectancy or the plan experiences poor investment returns.

Employers can help by offering employees either low-cost investment funds that minimize the drag on net returns due to investment management fees or carefully selected, actively managed funds with higher return potential.

The SCL/SOA analysis assumed that institutionally priced funds were charged investment management fees of 0.5% (50 bps) per year and that retail funds were charged 1.5% (150 bps) per year. The report compared institutional and retail pricing under two applications of systematic withdrawals.

With the first application of systematic withdrawals, the withdrawal amount was fixed at retirement and increased for inflation each year. The amount was paid until the employee died or savings were exhausted, whichever came first. In this case, the SCL/SOA report projected that the money in savings would last two to three years longer with institutional pricing compared to retail pricing.

The second application of systematic withdrawals determines the withdrawal amount as a constant percentage of remaining assets at the beginning of each year. Favorable investment returns increase retirement income, while unfavorable returns decrease income. In this case, the funds should last indefinitely, since the withdrawal amount is a small, fixed percentage of the remaining assets. The SCL/SOA report projected that after 10 years, the income amount would be 10% higher with institutional pricing, and after 20 years, the income amount would be 21% higher.

THE SCL/SOA RESEARCH INDICATED THAT WITH INSTITUTIONAL PRICING IN PLACE COMPARED TO RETAIL PRICING,

I) SAVINGS WOULD LAST LONGER OR

II) RETIREMENT INCOMES WOULD BE HIGHER

IMMEDIATE ANNUITIES

Immediate annuities guarantee that retirement income is paid for an employee's life, no matter how long the employee lives and what happens in capital markets. Payments are typically a fixed dollar amount, although it is possible to buy annuities that increase at a fixed rate or for inflation.

Employers can help by offering an annuity bidding service that finds the most competitive annuity purchase rate among reputable insurance companies at the time of retirement. Employers can further help by reducing transaction charges through bulk buying of annuities compared to buying on a retail basis. The SCL/SOA report states that:

COMPETITIVE BIDDING has the potential to increase retirement income by 10% to 20%.

REDUCED TRANSACTION CHARGES have the potential to increase retirement income by 4% to 8%.

EMPLOYERS CAN HELP BY OFFERING AN ANNUITY BIDDING SERVICE THAT FINDS THE MOST COMPETITIVE ANNUITY PURCHASE RATE.

HYBRID PRODUCTS

Hybrid products combine longevity protection with the opportunity to enjoy a higher retirement income if investments perform well.

One hybrid product commonly available in the US is a Guaranteed Minimum Withdrawal Benefit (GMWB). In the SCL/SOA study, GMWBs were studied in some detail. GMWB annuities attempt to combine features of systematic withdrawals with the lifetime guarantees of annuities. They offer employees the potential to increase their retirement incomes if investment returns are favorable, but income is protected if returns are unfavorable. In addition, it is possible for employees to access funds during retirement, and unused funds at death are available for a legacy. In addition to charging annual investment management fees, insurance companies also charge an annual fee for the added protection.

With institutionally priced GMWB products, the annual insurance and investment management fees can be as much as 200 bps lower as compared to retail products. In addition, the initial income amount can be 12.5% higher than with retail GMWB products. Due to the reduced fees, the SCL/SOA report projects that this gap in income will widen to 16% after 10 years and to 19% after 20 years. Another advantage is that the amount of remaining savings is exhausted six years earlier with the retail product, although the income continues due to the insurance guarantee.

THERE ARE MANY DIFFERENT VARIATIONS. MERCER'S RETIREMENT PLAN DESIGN OF THE FUTURE (CLICK HERE) FOR EXAMPLE, ADVOCATES AN APPROACH THAT COMBINES A MANAGED DRAWDOWN WITH LONGEVITY INSURANCE.

FURTHER BENEFITS OF EMPLOYER INTERVENTION IN THE RETIREMENT PHASE

Employers have the resources to complete the analysis and due diligence necessary to offer reasonable solutions for generating retirement income. This is a task that is beyond the abilities of most employees.

An employer-sponsored program of retirement income can help prevent loss of savings due to fraud or mistakes. By offering a program of retirement income-generating options, employers can help build confidence in older workers that enables them to retire knowing that they're financially ready, thus helping with workforce renewal issues. This is consistent with the original intent of the plan - to increase the retirement security of a company's employees.

For more on helping your employees secure a better retirement income, visit www.mercer.com/dc

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