TIAA

Separating facts from perception

The valuable role that in-plan annuities can play in retirement SECURE-ity

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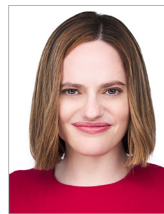

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While many of today's retirees rely on the stable income they enjoy from historical DB pension offerings, unfortunately, the market and demographic circumstances of the past few decades have made meeting the income obligations of DB pensions more expensive for employers.

Unbeknownst to most retirement plan participants, annuities inside Defined Contribution (DC) plans, such as 401(k) plans, serve a purpose akin to that of Defined Benefit (DB) plans: They provide the peace of mind that comes with receiving a guaranteed income stream for life in retirement. Employers can add annuities to a 401(k) plan investment menu after vetting with an advisor(s), a source employees trust to be looking out for their best interests and for the needs of the overall plan demographics.

The American Express Co. created **the first private pension plan** in the U.S. for the elderly and workers with disabilities in 1875.[1] According to **data compiled by Statista**, at that time, life expectancy at birth was 40 years, and has since risen steadily—nearly doubling to the 78.9-year figure quoted in 2020.[2] However, for those approaching retirement life expectancy at birth is meaningless. What's more important is life expectancy **at time of retirement.** For example, according to TIAA's 2022 dividend mortality tables, there's about a 50% chance that a single person age 65 will live to age 90 and about a 25% chance they will live to age 95. Include a same age spouse or partner and there's about a 45% chance that one member of the couple will live to age 95! Being blessed to live a long life in retirement is one of the primary risks that retirees need to mitigate, both for themselves and their spouses or partners.

While many of today's retirees rely on the stable income they enjoy from historical DB pension offerings, unfortunately, the market and demographic circumstances of the past few decades have made meeting the income obligations of DB pensions

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more expensive for employers. Excepting any potential effect of COVID-19, the U.S. has seen consistent life expectancy increases since at least the end of World War II. During this same period in which life expectancies have been rising, interest rates have been in secular decline. Either of these factors alone—the expectation of making lifetime payments for longer or the lower discount rate applicable to long-term liabilities—increases the cost associated with an employer offering a DB plan.

This combination of trends resulted in a negative impact to the corporate income statements of many employers offering DB plans. Instead of offering corporate sponsors a source of earnings with a positive contribution to the bottom line, as had been the case during the high interest rate environment of the 1980s, by the 1990s and 2000s, DB plan liabilities became a consistent corporate earnings depressor.

Not surprisingly, this effect caused CFOs to move away from DB plans and towards employer-sponsored DC plans as a primary retirement vehicle. Unlike DB plans that guarantee income, DC plans are non-guaranteed savings vehicles, and, therefore, do not meaningfully impact corporate financials. This shift from DB to DC caused risk-shifting away from expert liability-driven investors advising the DB plan—lifetime income retirement payments from which were "implicitly" backed by the assets of the DB plan and/or corporate assets—towards under-prepared individual DC plan participants, making it one of the largest and yet most under-reported risk-transference events in America's financial history. Where was the outcry from the financial press warning consumers about these trends systematically reducing the retirement security of everyday Americans throughout this period? The financial press, instead, was busy extolling the virtues of low-cost investment products labeled as "good," while labeling all annuities as "bad," giving little attention to the previously mentioned risk-shift from corporate balance sheets to consumers who are generally not equipped to assess or manage these risks.

It should be noted that up until about the latter part of the twentieth century retirees from DB plans were typically guaranteed to receive their lifetime income stream by way of an *annuity contract* that the DB plan entered into, thus absolving the plan's funds from making the payments to retirees and shifting that risk to the insurance company that issued the annuity contract. Then, a shift occurred and many DB plans stopped buying annuity contracts that provided an insured guarantee for their retirees' lifetime income. Rather, the sponsors of those DB plans began to make lifetime income payments directly from plan assets to the retiree under the assumption that their plan fund returns would outpace the returns assumed by the insurance companies in their annuity pricing. This change in practice contributed to the dramatic underfunding of DB pension plans that has been the subject of articles and research for several decades proving that it is not only consumers but also professional asset managers who fall prey to the economists' "annuity puzzle." It should also be noted that what's old is new—with perhaps some lessons learned—because, over the last five years, we have seen a resurgence in DB plan sponsors using annuity contracts to purchase their active and retired employees' lifetime income payment streams—the so-called "pension risk transfer (PRT) business"—eliminating these liabilities from the DB plan's balance sheet. While many may perceive the idea of using annuities in DC plans as a new concept, with annuities having historically been used first to fund DB payouts at a participant's retirement and then to lift liabilities off a plan's balance sheets through PRTs, the use of annuities to deliver secure income in the retirement space can hardly be viewed as without precedent.

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The emergence of the 401(k) market

401(k) plans came into existence as a result of the Revenue Act of 1978, and were intended to be an important supplement to the lifetime income benefit of DB plans, providing employees with a cost-effective outlet to save for discretionary expenses in retirement. They were not originally intended to serve as Americans' primary source of retirement income, and appropriately became the final leg in the three-legged stool that included lifetime income from Social Security and DB pensions along with the supplemental savings from 401(k) plans.

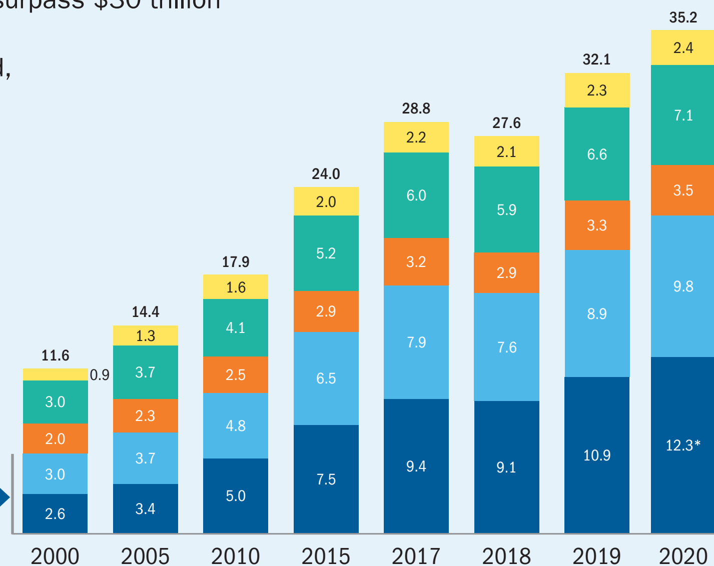
In 2020, 63% of Americans' qualified assets were in IRAs and DC plans, up from 48% of qualified retirement assets in 2000. It is no longer the case that the majority of American retirement assets are professionally managed for the explicit purpose of providing consistent, predictable lifetime income to last throughout retirement.

Participant-controlled assets now comprise the majority of the qualified retirement market

U.S. retirement market assets surpass $30 trillion

Trillions of dollars, end-of-period, selected periods

- Annuity reserves
- Government DB plans
- Private-sector DB plans
- DC plans
- IRAs



48% participant-controlled, non-professionally managed, not for the purpose of providing lifetime income—a supplement to guaranteed sources

More recently, the participant-controlled proportion of the qualified retirement market is **63%**—and growing. As the majority, these sources can no longer be viewed as supplementary

* Estimated
Source: Investment Company Institute[3]

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For example, according to the Employee Benefit Research Institute (EBRI), “Congress acted in 1986 to replace the defined benefit plan for federal civilian workers (CSRS) with a less generous defined benefit plan (FERS) and a generous 401(k)-type plan (TSP). This [could be perceived as an implicit] ‘endorsement’ by the government of ‘shifting’ from a stand-alone defined benefit plan to a combination of a defined benefit plan and a defined contribution plan to which employees can contribute an amount of their choice.”[4]

Only a third of respondents to the Alliance for Lifetime Income’s survey believe they will have enough income to cover their retirement expenses.

Now that DC plans have replaced DB plans as the primary source of American retirement wealth, and with income from DB pensions no longer universally available to most American workers, it has become essential that 401(k) plans offer sources of guaranteed lifetime income, such as annuities, to not only supplement lifetime income from Social Security (if available to the individual), but also, importantly, to replace lifetime pension income that, in decades past, would have been provided through DB plans. It appears that most regulators in Washington, D.C., agree with this viewpoint given the strong bipartisan support enjoyed by the SECURE Act passed in late 2019, which created a more conducive environment to including institutionally priced in-plan annuities inside DC plans.

According to The Economic Policy Institute, “While average (mean) retirement account savings grew between 2001 and 2016, this was due in part to the aging of the large baby boomer cohort, as older families have had more time to accumulate savings. The results are mixed when age is taken into account. Workers in their early 50s are slightly behind their counterparts in 2001, while those in their late 50s and early 60s are far ahead. Other age groups have seen only modest improvements in the new millennium. Rather than stagnation, we should be seeing rising 401(k) and IRA account balances at all ages to offset declines in defined benefit pension coverage and Social Security cuts.”[5]

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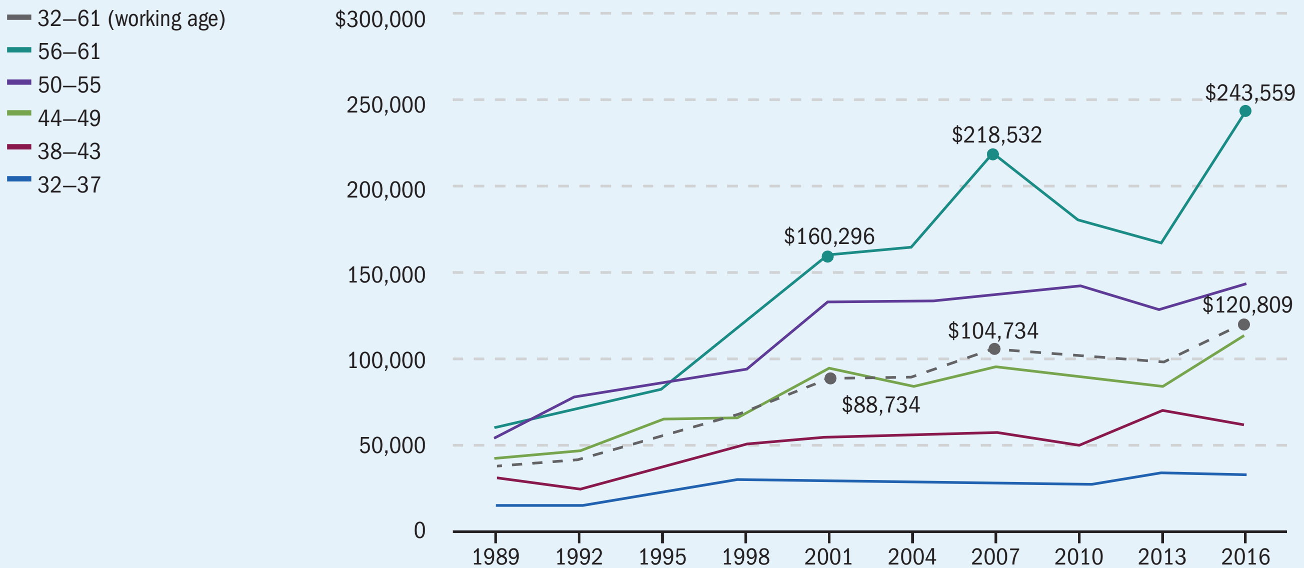

Note: Retirement account savings include funds in 401(k)-style defined contribution plans and IRAs.

Source: EPI analysis of Survey of Consumer Finance data, 2016[6]

Many people have misconceptions about annuities and, inspired in part by unfavorable and often under-educated media messaging, see all annuities as being the same inherently economically “unfair” financial instrument. TIAA and Fiduciary Insurance Services believe that clarifying some of these misconceptions can help plan participants achieve the peace of mind that only annuities can provide in the form of guaranteed lifetime income, along with accurately educating plan sponsors and consultants whose fiduciary duty it is to make good decisions about plan offerings that can protect their typically less-expert participants.

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As the members of the first generation of DC savers are now beginning to retire and are looking to turn their accumulated assets into the reliable income streams they will live on in retirement, these investors are challenged to understand how much they can safely afford to spend from their portfolios and to understand which product and program solutions might be well-matched to their needs. This decision making is complicated by conflicting media messages around what types of products and financial professionals a consumer should consider trustworthy with this unprecedentedly important set of decisions that center around the age-old—but answerless—questions of, "How much savings do I need to retire?" and "Exactly how long does my income need to last in retirement?"

Couple the aforementioned conundrum with interest rates at historic lows, unpredictable market returns, the real possibility of cognitive decline as we reach advanced ages, and the lingering effects of a global pandemic, and it's not surprising that a recent survey completed by the Alliance for Lifetime Income shows that only a third of respondents (33%) are very confident that they will have the income to cover all their expenses in retirement.[7] Use of annuities for lifetime income has proven time and again to increase consumer confidence in meeting their retirement income needs, yet many misconceptions about both the value that annuities provide to consumers, and about the operational and fiduciary aspects of including them in a DC plan, have historically led most DC fiduciaries to eschew adding annuities to a plan's menu.[8]

Enter the SECURE Act: Because "the times, they are a-changing"

In 2019, Congress passed the bipartisan Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), which includes several provisions intended to increase access to protected lifetime income as part of a broader package of retirement security measures passed. The SECURE Act includes an improved fiduciary safe harbor for selecting insurers to provide lifetime income solutions inside DC plans; it allows DC plans to adopt provisions allowing for portability of lifetime income options if the lifetime income option is removed from the DC plan menu; and it requires an annual lifetime income disclosure that translates account balances into expected income streams to be delivered to participants. With these protections now in place, it is time to begin clarifying some common misconceptions about annuities, the only product that can be added to DC plans to restore Americans' retirement confidence and provide income that can never be outlived.

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Common consultant and plan sponsor annuity concerns

Myth	Fact
Employees aren't demanding it yet.	Aon found that 80% of employees want some form of guaranteed income in retirement, and that more than 70% of plan sponsors agree their DC plan should include lifetime income options.[9, 10]
If I decide to remove the annuity product from my menu, I don't want to risk that participants lose the annuity benefits they paid for.	Today's in-plan annuity products and providers often have options to allow participants to port their balance and/or benefits to an individually held solution so that they may retain guarantees if the plan sponsor removes the annuity product from the menu.
If I decide to switch recordkeepers to one that doesn't offer the same annuity, I don't want to risk that participants lose the annuity benefits they paid for.	In response to both the SECURE Act and changing consumer needs and preferences, many recordkeepers are now exploring how to support these products, and many are considering adopting middleware that makes transitions from one recordkeeper to another seamless.
It is not clear what the fiduciary duty expectations are for annuities relative to traditional investments.	The SECURE Act has now laid out a clear set of criteria for fiduciaries to evaluate at the time of carrier selection as well as for ongoing monitoring.[11] This safe harbor uses state insurance regulators and an annual certificate provided to the employer confirming an insurer's solvency. This simplifies the insurer review process for employers, negating the need for them to conduct ongoing review of an insurer's capital requirements, liquidity and solvency. Instead, in summary, the employer is able to rely on written representations from the insurer, which must confirm that the insurer has complied with certain regulatory, financial reporting and auditing requirements; undergoes an examination by the insurance commissioner in its state of domicile at least every five years; and agrees to notify the employer of any changes in such circumstances.[12] TIAA's sample attestation letter is **here**. It should also be noted that several firms and industry groups have published and/or are working on materials to aid decision makers such as fiduciary guides and best practices templates. As one example, Fred Reish and Bruce Ashton of Faegre Drinker recently published a paper describing fiduciary considerations when using model portfolios, in particular, those that include lifetime income vehicles. The paper can be **accessed here**.

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Common consultant and plan sponsor annuity concerns

Myth	Fact
Annuity solutions are too hard to implement.	Annuities can be added in plan in as few as five steps: **1** Research and select the category of lifetime income solution (e.g., fixed annuity, SPIA, QLAC, GMWB), the provider and the specific product (with help from your plan's advisor/consultant, if applicable). **2** Amend the plan to allow annuitization as a distribution option and to allow removal of the lifetime income product to be considered a distributable event (i.e., participant portability). While amending the plan, sponsors may also wish to ensure that their plan allows for partial distributions and doesn't force retirees to withdraw their full balance even if they only want to withdraw some money, a flaw often found in many plan documents. **3** Notify plan participants and beneficiaries. **4** Modify the summary plan description and the election benefit form. **5** Establish procedures for administration and Form 5500 filing.[13]
Participant use of annuity solutions is low.	QDIAs, such as target-date funds, managed accounts and custom model portfolio services that include an annuity component with an accumulation value, can increase the use of a payout annuity benefit.[14, 15] Some annuity products, such as certain fixed annuities offered by TIAA, have the potential to pay more lifetime income per dollar annuitized based on length of time the contribution was on deposit, so including these products inside QDIA vehicles can help build a more competitive foundation of lifetime income versus contributing later in life.
Plan sponsors are not able to drive simpler annuity communications to participants, so participants don't enroll in annuity solutions when offered.	Many successful strategies have been implemented to educate plan participants about new plan offerings that contribute to financial wellness, including the often-cited program implemented by United Technologies (now Raytheon).[16]
I hear from financial pundits that annuities are bad for meeting retirement needs, because they keep the purchaser's money locked up.	In a survey conducted by Towers Watson, retirement satisfaction rates rose precipitously the greater the proportion of their wealth the respondent had annuitized. Results rose from 44% satisfaction among those with no annuities to 65% in the last surveyed year from among those with >30% of wealth annuitized.[17] 80% of consumers view guaranteed lifetime income in addition to Social Security as valuable (5 or more out of 7).[18]

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Myth	Fact
Annuities are always expensive, meaning that the cost for buying them is higher than the objective value of the guaranteed income they offer.	**Research sponsored by the Society of Actuaries demonstrates that retirement-income-generating solutions that include annuities often produce materially more income than do solutions that do not include annuities.**[19] Further, institutional annuity options offer value. According to Lincoln Financial Group, "In general, when compared to retail options, low-cost institutional retirement income solutions have the potential to increase retirement income by 10% to 20%. Offering in-plan, guaranteed lifetime income solutions allows participants to benefit from institutionally priced programs—and potentially higher incomes—throughout retirement."[20]
Annuity rates are low right now—I will wait until rates rise before considering them.	Safe portfolio withdrawal rates may be materially lower than they have been in the past, with some prominent retirement researchers citing "safe" self-initiated/self-adjusted, non-guaranteed systematic withdrawal rates as low as 2.4% (versus the 4.00% rule of thumb).[21] Meanwhile, **the Alliance for Lifetime Income**, a non-profit 501(c)(6) educational organization that creates awareness and educates Americans about the value and importance of having protected lifetime income in retirement, makes the case that, with interest rates as low as they are, now may be the most valuable time to purchase an annuity.[22] Annuities are the only income source guaranteed to pay out a retirement income as long as you live.[23]
If the purchaser dies shortly after purchasing a stream of lifetime income through an annuity solution, the insurance company will keep the purchaser's money and heirs will lose out.	Many fixed annuities that protect against this risk already exist in the in-plan space. These features include joint life annuities, as well as the potential to add a 20-year guaranteed period to the annuity's payout, which means that even if you die before the end of the 20-year period, you and your heirs will in total typically receive at least the amount of principal you put in to buy the annuity. An important point about joint life annuities is that pre-selecting income to continue distributing to a spouse or partner after death can make it easier for the surviving individual who may not have been involved in the couple's financial planning. An additional feature is a "return of premium" death benefit, which means that you and your heirs will in total receive at least the amount of principal you put in to buy the annuity. Further, when using a deferred annuity that includes a living benefits rider such as a guaranteed minimum/lifetime withdrawal benefit, the policy's remaining cash value becomes available to heirs upon the passing of the annuitant and is not paid to the insurer.

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Conclusion

The central role that annuities have played in securing guaranteed lifetime income for generations of Americans, including for DB plan participants, has historically been misunderstood, mischaracterized, and undervalued. Only by risk pooling can a plan participant, not knowing how long they individually will live, feel safe receiving and spending a higher income amount than prominent academics say is a safe, non-guaranteed withdrawal rate in today's challenging market environment. Annuities are the only currently available commercial product that enable risk pooling. Without the security of DB plans, and with Social Security's trust fund depleting more rapidly than expected, America's traditional three-legged retirement stool is looking increasingly lopsided. Now, more than ever, is the right time for plan sponsors to begin exploring how the addition of in-plan, institutionally priced annuity products to their 401(k) plan, as part of a holistic retirement income solution, can help employees retire with the confidence they need to enjoy the lifestyle they'd envisioned for retirement.

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[21] ThinkAdvisor, "Wade Pfau: Pandemic Tears Up 4% Rule," April 2020

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[23] Subject to the claims-paying ability of the insurer

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