Georgetown University
Center for Retirement Initiatives
McCourt School of Public Policy

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A Key to Strengthening Retirement Security: Return to Designing Retirement Plans Focused on Lifetime Income Strategies

By Martin Noven and Angela M. Antonelli

As employers have shifted from traditional defined benefit (DB) pension plans to defined contribution (DC) plans, many unintentionally abandoned the goal of retirement security. Most employers making the shift from DB to DC plans did so to manage the financial obligations associated with maintaining DB plans. Unfortunately, rather than creating a DC plan designed to provide their employees with a predictable stream of retirement income, most employers simply opted to match contributions to existing 401(k) retirement plans, effectively turning the management of their savings over to employees.

The problem with relying on a supplemental DC plan as a core or primary retirement plan is that supplemental DC plans were not designed to provide retirement security. These DC plans were intended to supplement not supplant traditional DB pension plans. Supplemental DC plans were designed as tax advantaged savings vehicles for workers whose basic needs in retirement already would be met by a traditional DB plan. As a result, these core DC plans are primarily focused on wealth accumulation and preservation while failing to offer workers options to help them manage their income to last a lifetime.

Demographic and Economic Trends Demand the Consideration of Lifetime Income Strategies

The World Economic Forum (WEF) recently issued a report entitled "We'll Live to 100 – How Can We Afford It?" The report title succinctly sums up the demographic and economic challenges for future generations of retirees. More than 800,000 Americans aged 65 or older retired in the last quarter of 2016, 10,000 baby boomers are retiring each day now and the number of retirees is expected to grow by 60 percent between 2014 and 2040. Life expectancy has been steadily increasing during the past century. Today's twenty-year-olds are projected to live to be 100 and today's ten-year-olds are expected to live to be 103. But how well does living longer match with the realities of aging, workforce participation, and lifetime earnings? Is it possible to have sufficient income in retirement if you are likely to work at most 45 years out of those 100 years?

For policymakers, the time is now to consider what an increasingly older population means for the sustainability of our retirement system. This must include the consideration of lifetime income strategies in core DC plans.

Account Balance Is Not the Proper Measure of Retirement Security

Your retirement savings account balance tells you little about whether it will be enough to meet your needs in retirement. Yet, the focus of today's core DC plan has been primarily wealth accumulation and preservation. A wealth accumulation and preservation goal is appropriate for a supplemental savings plan but not for what DC plans have become—the primary way to save for retirement. The goal of wealth accumulation only makes sense when it is intended to help an individual purchase things that they want in retirement *after* their basic needs are met. For example, if a participant wishes to make voluntary contributions in order to buy a $250,000 vacation home in retirement, the participant needs a plan that is designed to accumulate $250,000 and subsequently preserve those savings until they purchase the home. The risk is that he or she will have less than $250,000 in retirement. If the participant accumulates less than $250,000, or fails to preserve the $250,000 after it is accumulated, the participant will be unable to make the purchase.

If the goal of a retirement plan is to help each participant generate enough income in retirement to maintain his or her standard of living, or at least meet their basic needs in retirement, the retirement plan should be designed to address the risk that the participant will be unable to replace an adequate percentage of preretirement income. If retirement security is the goal, the amount of assets that participants accumulate is less important than the amount of income the participants can generate from those assets in retirement.

Effectively Managing Income in Retirement Is More Important

If DC plans provide the primary source of income in retirement, policymakers must move beyond a focus on inputs—the amount of savings—to a focus on outcomes—whether retirement savings plans improve and enhance income adequacy in retirement. As more and more assets are being distributed, or withdrawn, from plans at the time of retirement, policymakers need to examine how this decumulation of funds is occurring. Today, many workers in DC plans take the distribution of funds at retirement as a lump sum because it is their only option.

Unfortunately, what people might perceive as a sufficient amount of money for their retirement is often not enough. They fail to take into consideration factors such as how much income per year they need, or unexpected healthcare or family expenses that will have a serious impact on their retirement income needs. A recent MetLife study found that 20 percent of retirees taking a lump sum spent all of their retirement savings in five and a half years. Other participants have a difficult time transitioning from saving to spending and live a lower quality of life than necessary because they are not comfortable spending the money they have saved.

Policymakers and Plan Sponsors Must Give Participants Greater Options for Lifetime Income

To provide retirement security, plan sponsors need to provide participants distribution options at retirement other than lump-sum distributions. While financial education initiatives can have an impact on participant savings rates, it is unrealistic to expect that we can arm participants with enough financial expertise to put most retirees in a position to develop their own distribution strategies.

The U.S. Department of Labor (DOL) has previously agreed that lifetime income is an important public policy issue. To encourage policymakers and plan sponsors to focus on retirement security, the U.S. Government Accountability Office (GAO) has recommended that DOL should provide greater guidance to plan sponsors regarding lifetime income options. The qualified default investment alternatives (QDIA) regulations were very effective in moving participants from stable value funds toward target date funds. Similar action by the DOL could make it easier for plan sponsors to move participants in core defined contribution retirement plans to solutions designed to provide retirement security to participants.

A recent survey of large employers by Aon Hewitt shows that most still do not offer, and are not likely to offer, options that help participants convert their savings plan account balances into lifetime income. The easier policymakers make it for plan sponsors to offer effective distribution strategies, such as lifetime income solutions and/or structured withdrawal options, the more time and resources the industry will commit to developing those solutions and increase the likelihood more employers will adopt them.

Martin Noven is the Executive Director of the Illinois State Universities Retirement System (SURS) and an advisor to the Center for Retirement Initiatives (CRI) and Angela M. Antonelli is the Executive Director of the CRI.

Additional Resources:

American Academy of Actuaries, "Retirement Income Options in Employer-Sponsored Defined Contribution Plans," October 2017.

Aon Hewitt, "2017 Hot Topics in Retirement and Financial Wellbeing."

MetLife, "Paycheck or Pot of Gold Study," April 2017.

TIAA, "Closing the guarantee gap: How policymakers can restore the role of lifetime income in workplace retirement plans," 2017.

U.S. Government Accountability Office, 401(K) Plans: DOL Could Take Steps to Improve Retirement Income Options for Plan Participants, GAO-16-433, August 2016.

World Economic Forum, "We'll Live to 100 – How Can We Afford It?," May 2017.