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RETIREMENT INCOME SOLUTIONS:

DC Plan Participants Look to Transfer Risk

SUMMARY

In response to market events over the past three years and new investor attitudes towards the role of defined contribution plans, Plan Sponsors and Participants alike are demanding new investment products aimed at addressing both capital market and longevity risk. The investment industry has introduced new products to the defined contribution market, broadly termed "Retirement Income Solutions," to meet investor demand and to attempt to overcome these risks.

The emergence of any new product introduces unique challenges and risks to both Plan Fiduciaries and Plan Participants. In this paper, CAPTRUST examines the Retirement Income product landscape as it exists today, with a special emphasis on products that feature guaranteed income components.

While Retirement Income Solutions have received industry-wide attention, including an inquiry from the Department of Labor (DOL), there are very few products in the marketplace. Fewer still have had much success. Despite evidence that Plan Participants value lifetime retirement income, defined contribution Plan Sponsors have been slow to adopt Retirement Income Solutions due to concerns over cost, portability, provider selection, and participant education. As the industry races to solve these concerns, Plan Sponsors will be forced to assess increasingly complicated and evolving products. In evaluating Retirement Income Solutions, it is essential that Plan Sponsors understand the mechanics, benefits and risks associated with these new products as they think holistically about designing and managing a successful defined contribution plan.

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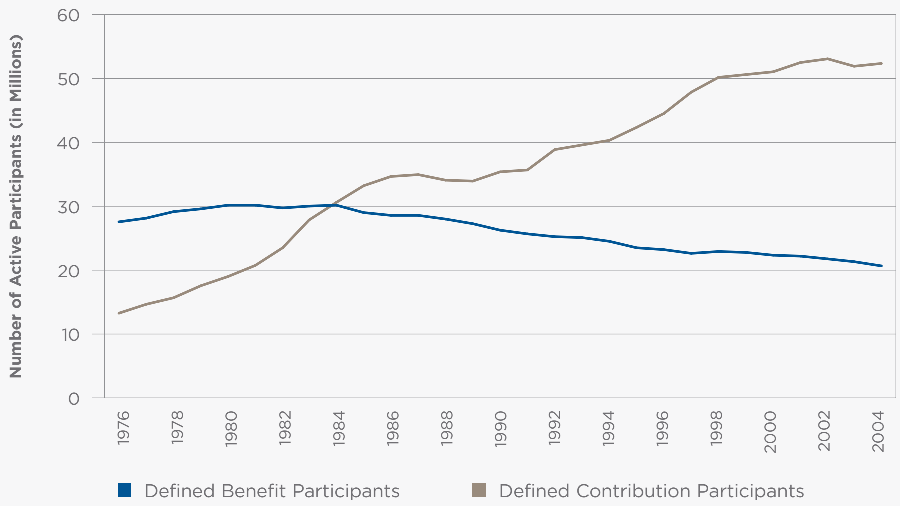
2011 marks the 401(k) plan's 30th birthday. While it was originally intended to be a supplement to traditional retirement income sources (such as Social Security and employer-sponsored defined benefit plans), the 401(k) plan quickly overtook the defined benefit plan in terms of popularity and availability. This development revolutionized the retirement industry, changing the way Americans save and ultimately spend their retirement dollars.

Defined benefit plan popularity began its decline in the 1980s, and by 1984, defined contribution plans, such as the 401(k) plan, had surpassed traditional defined benefit plans in total number of Participants.[1] As Exhibit 1 illustrates, while participant enrollment in defined contribution plans steadily increased over the last 30 years, participant enrollment in defined benefit plans fell by over 25% during the same time period.

Exhibit 1: Active Participants by Type of Plan



Source: U.S. Department of Labor, Employee Benefit Research Institute. "Private Pension Plan Bulletin Historical Tables and Graphs." February 2009, Table E8.

According to the U.S. Bureau of Labor Statistics, as of March 2008 (see Exhibit 2), the percentage of workers with access to a defined contribution plan was nearly three times the percentage of those with access to a defined benefit plan.[2] This shift has resulted in a transfer of certain risks from the employer to the employee. Notable risk exposure for defined contribution Plan Participants includes capital market risk (investment risk), under-accrual risk (the risk of not saving enough), and longevity risk (the risk of outliving one's money). Defined contribution Plan Sponsors, consultants, product providers, and record keepers have spent the last 30 years addressing the first two risks, focusing on asset allocation, participant savings rates, and asset accumulation tools. However, recent market events, including the worst decline in financial markets since the Great Depression, have created demand from Plan Sponsors and Participants alike for solutions that specifically address both capital market and longevity risk.

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Exhibit 2: Access and Participation Rates for All Private-Industry Workers, March 2008 Survey

Access and Participation Rates for All Private-Industry Workers, March 2008 Survey		
Type of Retirement Plan	Access Rate	Participation Rate
Defined-benefit plan	22%	20%
Defined-contribution plan	62%	43%

Source: U.S. Bureau of Labor Statistics. "Defined-contribution plans more common than defined-benefit plans." Program Perspectives, Issue 3

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Participants and Plan Sponsors are increasingly expressing concern over the distribution phase—specifically protecting capital as Participants near and transition into retirement as well as retirees outliving their monies. The recent distribution phase focus is not without merit. In 2010, Allianz Global Investors conducted a nationwide survey of over 3,000 adults ages 44 to 75, focusing on investor's attitudes towards retirement income and security. According to the survey, between 58% and 60% of respondents across age groups reported worrying about longevity.[3] Additionally, 61% of respondents noted that they were more afraid of running out of assets than they were of dying, with the concern even higher among older populations. This survey suggests that the migration away from defined benefit plans has created a need for retirement income, and that Participants place a higher value on certainty rather than portfolio growth potential. To illustrate, 80% of Participants responding to the Allianz survey said they would prefer a product that carried only a 4% return, but was guaranteed not to lose money, versus a product that offered an 8% return but was vulnerable to market downturns.

DEFINING THE OPTIONS

There are currently two main structures of Retirement Income Solution products: **Guaranteed Minimum Withdrawal Benefit (GMWB)** and **Guaranteed Minimum Income Benefit (GMIB)**. Though both product types seek to address longevity risk, their structures are distinct and their differences are meaningful. ■

GUARANTEED MINIMUM WITHDRAWAL BENEFIT

Within a retirement plan context, a Guaranteed Minimum Withdrawal Benefit (GMWB) is typically a target date series or other asset allocation fund embedded with a unique insurance provision. Throughout an investor's career, contributions to the GMWB are made similar to any other investment product in the plan. However, as a Participant gets closer to retirement—typically ten to fifteen years prior to retirement—the Participant's principal invested in the GMWB is guaranteed[4] against loss of value per the contract terms. At the point the guarantee becomes effective, the amount invested in the product is used to calculate a "benefit base," or the sum of all investment contributions into the product, including any upward adjustments from market appreciation to date and minus any withdrawals made. The benefit base amount is ultimately what will be used to calculate the guaranteed payout amount an investor will receive in retirement. It is important to note that the benefit base amount is protected from losing value as long as the investor remains invested in the product and follows the product's terms. Additionally, most GMWB products offer the investor the ability to "step-up" their benefit base after establishing the initial value (typically once a year) and lock in their benefit base amount if the market value on that date is greater than the previously established benefit base. In the case of a step-up, the market value becomes the new benefit base. On years when the fund's underlying market value is less than the benefit base amount (on the step-up date), no upward revision to the benefit base will be made. Some GMWBs substitute this common annual step-up provision for a guaranteed annual return, and only offer one chance to lock in a higher benefit base, typically at the date of retirement.

> **The distinction between market value and benefit base is important—an investor's market value is the actual underlying value of all contributions made into the fund plus market gains (or less losses) and minus any investment management and insurance fees assessed.**

An investor's market value will fluctuate daily based on market conditions. In contrast, an investor's benefit base is the sum of all contributions made into the fund, factoring in any

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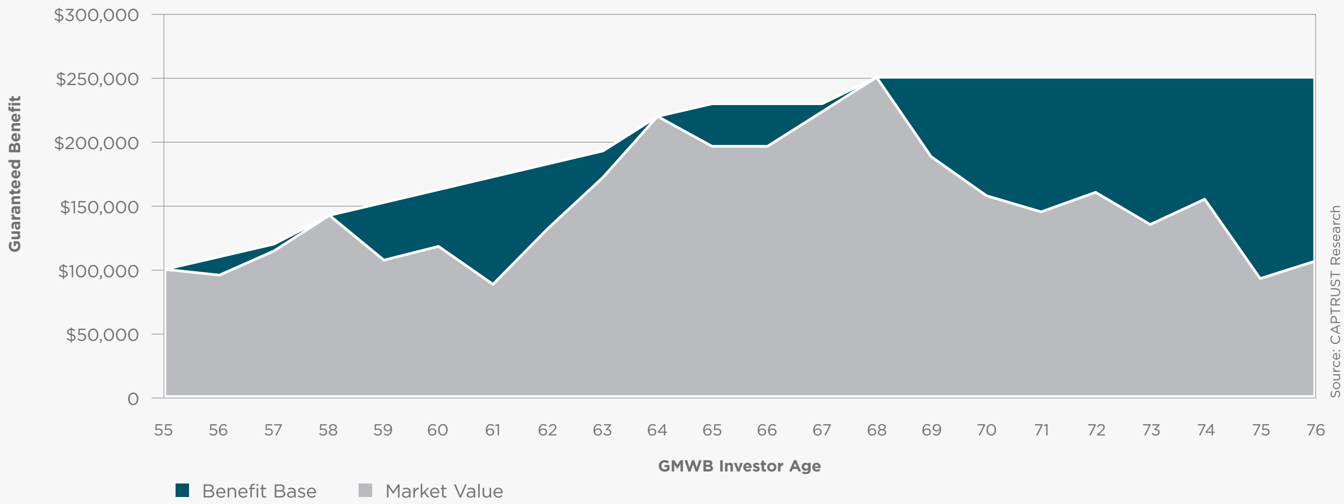
step-up adjustments and less any investor withdrawals. The benefit base is the amount used to calculate the guaranteed payout amount and will never decrease over the life of the product (unless the investor withdraws capital beyond the agreed upon amount and timing).

Per the product terms, GMWB investors are guaranteed to receive income—typically a stated percentage of their benefit base amount for the remainder of their life (or their spouse's life if a joint option is chosen)—irrespective of how the market or the underlying fund performs. When a Participant reaches retirement age and elects to exercise their guarantee, the provider calculates a guaranteed monthly payment using the investor's current benefit base. Assets will stay invested in the capital markets per the product design chosen and the market value will rise or fall depending on the underlying product's performance, but the benefit base can never decrease from capital market fluctuations or allowable distributions. Importantly, most products allow for the benefit base to continue to increase or step-up in the future even after the guarantee has been exercised and withdrawals have begun. In retirement, the benefit base is typically reset annually to the higher of either the market value or the current benefit base amount. Thus, the investor has the opportunity to participate in market growth while the guaranteed monthly payments are insulated from down markets. It is important to note that while the monthly payment is insulated from market losses, an investor's underlying market value is never guaranteed. In addition to down market protection, with a GMWB feature, investors never give up control of their money. Investors may choose at any time, even after exercising the contract, to void the guaranteed payment and withdraw their market value from the product. Additionally, during retirement, an investor's monthly income is drawn directly from the participant's own assets until those assets are depleted. It is only when the investor's market value reaches zero that the insurance company will begin to make payments out of its pocket. If the market value never reaches zero prior to an investor's death, any remaining assets can be transferred to named beneficiaries. Exhibit 3 demonstrates the investor experience in a hypothetical GMWB product.

Exhibit 3: GMWB Example, Benefit Base vs. Market Value
Investor Experience in a Hypothetical GMWB Product



Hypothetical Example (See Exhibit 3): John allocates $100,000 to a GMWB fund at age 55 and then $10,000 annually over the next 10 years. At the initial point of investment, his market value, $100,000, is equal to his benefit base. On John's 56th birthday, poor market performance has caused his market value to decline to $95,000. His current benefit base is $110,000 ($100,000 investment + $10,000 annual contribution), and because his benefit base is higher than his market value, John's benefit base will remain at $110,000. Two years later, on John's 58th birthday, his market value is $142,500, $12,500 higher than his current benefit base of $130,000 (initial $100,000 investment + $10,000 annual contribution over three years). Since John's market value is higher than his benefit base on his birthday, John's benefit base will step-up to the higher amount of $142,500. By age 65, John has experienced two step-ups and his benefit base is now $230,000. Based on this amount, John is guaranteed to receive an annual payment of $11,500 per year ($230,000 x 5% = $11,500) for the remainder of his life. This annual payment will be drawn directly from John's market value each year in retirement.

Post-retirement, the investor still retains the ability to step-up his benefit base to a higher amount annually.

Post-retirement, he still retains the ability to step-up his benefit base to a higher amount annually. Three years into retirement, on John's 68th birthday, his market value is $250,000, which is higher than his benefit base of $230,000, due to market growth. His annual guaranteed payment is now $12,500 ($250,000 x 5% = $12,500). This amount will be drawn directly from his market value going forward and can never decrease. Twenty years into retirement, John's market value has reached zero, however he will continue to receive his annual payment of $12,500 for the remainder of his life, as guaranteed by the product's insurer. ■

GUARANTEED MINIMUM INCOME BENEFIT

In a typical Guaranteed Minimum Income Benefit (GMIB) format, investors purchase deferred annuities throughout their career within the construct of an asset allocation program. Some product providers only allocate a portion of the investor's contribution to traditional or variable annuities, with the balance invested in more traditional asset classes such as equities and fixed income, while other providers choose to allocate the entire contribution to annuities. For either variation, the guaranteed rate offered by the annuity portion of the product will change throughout the accumulation phase and will fluctuate with overall changes in interest rates and in some cases, an investor's age. Typically, a GMIB product will offer annuities through only one insurer who will set the rate for the product each year at comparative rates with other insurance providers offering a similar benefit. The insurer will generally reset the guaranteed rate once a year with all future contributions for that year receiving the new guaranteed rate. Past contributions are grandfathered into the rate offered for each prior year. The intent of this framework is for investors in a GMIB to dollar-cost average into a guaranteed rate over time, an approach designed to mitigate the point-in-time interest rate risk usually taken by investors when buying a single annuity at retirement.

With a GMIB, the Participant annuitizes their contracts at retirement and the annuity portion of the assets are subsequently transferred to the insurance provider. In return, the insurer provides the investor a guaranteed stated monthly income for the remainder of their life (or their spouse's life if a joint/survivor option is chosen). At this point, the Participant loses control over the assets dedicated to annuities within the product (although they will retain access to any portion of the portfolio invested in non-annuity assets, which will continue to participate in any potential market growth or losses). Regardless of the individual product's mechanics, an important characteristic of all GMIBs is that only the annuity portion of the fund is guaranteed; an investor can lose money in any portion of the product not guaranteed by an insurer.

Hypothetical Example: Judy allocates $5,000 annually to a GMIB fund over a 30-year period. A certain percentage of these assets, (50% in this example), are allocated to purchase deferred fixed annuities. The payment received in retirement is determined at the time of purchase, and these "income units" accrue throughout the investor's career. At retirement, Judy annuitizes these contracts, forfeiting 50% of her capital in exchange for monthly income guaranteed by the insurer for the remainder of her life. In this case, the sum of Judy's accumulated income units is $7,000 per year. The other 50% of money she contributed will continue to be invested in the market through the underlying fund and may either grow or lose money in the future depending on market conditions. ■

PLAN SPONSOR CONSIDERATIONS

If used appropriately, a Retirement Income Solution can provide retirees in defined contribution plans a "paycheck for life" similar to a defined benefit plan. However, most Plan Sponsors have been hesitant to offer these products due to issues such as cost, portability, safe harbor protection, and a lack of clear direction and from the Department of Labor on provider selection. In recent testimony to the Department of Labor and the Treasury, the Society of Professional Asset-Managers and Record Keepers (SPARK Institute) noted that:

> *The requirements under the current DOL annuity safe harbor are considered to be so difficult to satisfy that offering a retirement income solution can be viewed as doing more harm than good [to the Plan Sponsor].*[5]

The most current guidance for Plan Sponsors when selecting these types of products for a defined contribution plan comes from the DOL's Interpretive Bulletin 95-1. This bulletin states that a plan fiduciary has the duty to "conduct an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities."[6] The plan fiduciary has the responsibility to conduct this analysis by looking at a number of factors, including costs in relation to the benefits received[7] and the ability of an annuity provider to satisfy all future annuity claims under the contract.[8] This requires Plan Sponsors to demonstrate a clear understanding of Retirement Income Solutions, including their structures, mechanics, fees (explicit and implicit), benefits, and other considerations such as portability across a small but growing product set, as well as make a determination on the future claims paying ability of the insurance provider in question.

Factors affecting a Plan Sponsor's decision to offer a Retirement Income Solution vary widely from plan to plan and are based on each population's individual needs. An employer who previously offered a defined benefit plan may find particular value in adopting a Retirement Income Solution within its defined contribution plan. Similarly, an employer with an older workforce may find the protection from capital market risk and a guaranteed income stream provided by Retirement Income Solutions more attractive than would a company with a younger workforce. The number of unique situations for Plan Sponsors is endless, and while the retirement industry may broadly advertise these products as "solutions," we feel they are not necessarily the right solution for all retirement plans.

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Because of differences among products, considerations will vary by solution, but there are certain universal factors for Plan Sponsors to consider across products. According to a paper by Fred Reish, Bruce Aston, and Joe Faucher, Plan Fiduciaries "owe a legal duty to their Participants to consider the relevant factors" surrounding product selection. These factors include (1) cost, (2) portability, (3) financial strength of the insurer, and (4) participant education.[9]

1. COST

Retirement Income Solutions introduce new fees to Participants. In addition to the fees paid to the underlying investment managers, GMWB and GMIB products charge a "fee for guarantee" or insurance premium. In a GMWB format, these fees typically take effect around ten years prior to retirement and continue to be assessed on an investor's market value during retirement for the life of the Participant (meaning that these costs could be netted out of an investor's market value for an average of 20-40 years). While institutional pricing is a valuable Retirement Income Solution benefit, fees vary widely among products, from 0.50% all-in to a high of 1.70%.[10] Additional fees for an IRA rollover product may also apply. Plan Sponsors must be aware that the costs for the annuity portion of GMIBs are typically implicit (that is, insurers quote the monthly rate net of these fees, and Participants may not readily understand how much of their money goes towards fees).

Implicit or otherwise, Plan Fiduciaries should strongly consider product costs when evaluating Retirement Income Solutions.

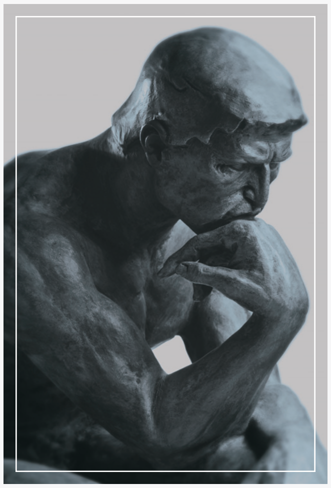
2. PORTABILITY

Most Retirement Income Solutions have limited availability among record keepers. Of the products currently open to investment, most are only available on a handful of record keeping platforms, meaning, once a product is introduced to a plan, changing record keepers becomes complex. In the event the Plan Sponsor moves to a provider that cannot accommodate the product, Participants may lose their ability to contribute to the program, may be forced to roll their assets into an IRA (incurring additional fees) or may be required to liquidate the investment and lose any accrued income guarantee (and not recoup fees already paid into the program). This complexity may also have an impact on the attractiveness of the total plan, thus affecting costs Participants pay for record keeping. While portability is currently an issue for these products, Retirement Income Solution providers and record keepers are working diligently to remove this roadblock.

In September 2010, the SPARK Institute issued its final proposal for standardizing data records related to Retirement Income Solutions. The SPARK Institute hopes that implementing these information standards among record keepers will eventually eliminate product portability issues going forward.

3. FINANCIAL STRENGTH OF THE INSURER

A Retirement Income Solution's key benefit is the monthly income retirement guarantee it affords. However, this guarantee is only as good as the insurer's ongoing financial strength and solvency. When considering a Retirement Income Solution's inclusion in a plan or when conducting peer comparisons, Plan Sponsors should be careful not to let product structure and features overshadow the key issue: the claims-paying ability of the guarantor. The provider's ability and intent to maintain and service the product in the future, stability of the company's financial ratings, as well as the backstop provided by each state's respective guaranty association or program are all also important considerations.



4. PARTICIPANT EDUCATION

While adding a Retirement Income Solution into a retirement plan introduces several complications for Plan Sponsors and record keepers, it can be equally complicated for Plan Participants. Ideally, the product provider or record keeper would supply educational materials to all Plan Participants as well as provide ongoing educational support for current and prospective investors in the program. Plan Sponsors should consider whether the available resources will be sufficient to ensure that Participants are able to make well informed decisions. Costs are also a consideration, although ideally there would be no additional fee for these educational services. ■

PRODUCT ADOPTION TRENDS

Despite evidence that Plan Participants value guaranteed income in retirement, Plan Sponsors have been slow to adopt Retirement Income Solutions. A recent Deloitte survey of Plan Sponsors shows that less than 5% of retirement plans currently offer a Retirement Income Solution, while only 12% of Plan Sponsors indicated that they are currently considering adding one to their plan.[11] Plan Sponsor hesitation continues to hinder widespread product adoption. While only a handful of products are currently operational, the sum of all assets (as of February 2011) currently invested in these programs is less than $2 billion.[12] Some products currently being marketed to Plan Sponsors have not yet been funded (that is, they currently do not manage any assets at all). Exhibit 4 provides a snapshot of current GMWB and GMIB products available in the market.

Exhibit 4: Snapshot of Current GMWB and GMIB Products

Product Provider	Launch Date	Current Assets Under Management	Number of Plans Currently Utilizing the Product
GMWB #1	Jan-10	$800 M	2,600
GMWB #2	Dec-10	$400 M	7,000
GMWB #3	Jan-10	$79 M	700
GMWB #4	Dec-10	$0	5
GMWB #5	Nov-10	$0	0
GMIB #1*	Jan-10	< $100 M	45
GMIB #2	Jan-10	$0	0
GMIB #3	2012 Anticipated Launch Date	$0	0

Source: Numbers are estimates gathered directly from product providers, February 2011
*Not available to new investors as of January 2011

While low market penetration is a primary concern for product providers, these providers have also had difficulty settling on the optimal product structures. Recently, several products have experienced meaningful changes in structure and design. One such change is a general shift away from active management of guaranteed assets toward passive or enhanced-index strategies. Other developments include increased availability of third-party investment managers, modified product fees, and adjusted benefit base calculations. Even after this flurry of change, more is expected as industry players speculate about the potential for reduced or variable guaranteed payout ratios, and the first multiple-insurer-backed product's viability in the marketplace. To further complicate the matter, some products have been pulled from the market altogether while several insurers are said to be considering introducing new products of their own.

Since these products emerged a few years ago, the market has generally gravitated toward GMWBs rather than GMIBs. In 2008, Jeffrey R. Brown et al authored "Why Don't the People Insure Late Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle." In the paper, the authors argue that because Participants tend to view annuities as investments rather than insurance of future consumption, they are inclined to avoid the perceived risky payoff associated with an unknown death date.[13] This hesitation means that GMIBs, which require a Participant to waive the right to their asset base in return for a fixed payment until death, are fighting an uphill market share battle. In early 2011, the largest GMIB provider (by assets) announced plans to shut down their product to new investors, leaving few GMIB alternatives in the space. ■

CONCLUSION

If we liken the product evolution of Retirement Income Solutions to a baseball game, we are only in the first or second inning. Despite their nascence, Retirement Income Solutions have received significant attention because of their advertised and perceived value for Participants: retirement income insulated from market swings and guaranteed to investors regardless of the length of their retirement.

Retirement Income Solutions will likely increase in popularity and concurrent asset growth going forward, as many Plan Sponsors desire to provide defined benefit-like certainty to their defined contribution Plan Participants, in response to a clear desire for guaranteed income. Product growth would be greatly expedited by the establishment of industry selection and monitoring standards, clarity on safe harbor for Plan Sponsors, solutions for product portability, and a better focus on framing the benefits of these products at the Plan Participant level. CAPTRUST is committed to not only monitoring the progress of the industry, but also to being a part of the solution. We welcome your questions and feedback on this important, emerging topic as we work to shape positive outcomes for Plan Sponsors and the Participants they serve. ■

Sources:

[1] U.S. Department of Labor, Employee Benefit Research Institute. "Private Pension Plan Bulletin Historical Tables and Graphs." February 2009, Table E8.

[2] U.S. Bureau of Labor Statistics. "Defined-contribution plans more common than defined-benefit plans." Program Perspectives, Issue 3, March 2009.

[3] Allianz Life Insurance Company. "Reclaiming the Future." 2010. https://www.allianzlife.com/MediaCenter/RTF_WhitePaperFindings.aspx.

[4] References to a guarantee in this paper refer to the product provider's legal obligation to provide investors with a promised return stream, subject to solvency and state-specific insurance oversight.

[5] Goldbrum Esq., Larry H. and Susan Unvarsky. Written Testimony from the Lifetime Income Solutions for Retirement Plans Joint Hearing before the United States Department of Labor, Employee Benefits Security Administration and the United States Department of the Treasury. September 2010. Available at http://www.dol.gov/ebsa/regs/cmt-1210-AB33.html.

[6] Interpretive Bulletin § 2509.95-1(c).

[7] ERISA Regulation § 2550.404a-4(b)(3).

[8] ERISA Regulation § 2550.404a-4(b)(4).

[9] Reish, Fred and Bruce Ashton and Joe Faucher. "Fiduciary Considerations in Offering a Lifetime Income Feature to 401(k) Participants." June 2009. http://iricouncil.org/articles#.

[10] Collected from CAPTRUST RFIs submitted to six major Retirement Income Solution providers, May 2010.

[11] Deloitte LLP. "Retirement Readiness of Employees is Top Priority for Employers." 2011. https://www.deloitte.com/view/en_US/us/press/Press-Releases/f018a1e199b5d210VgnVCM1000001a56f00aRCRD.htm.

[12] Based on estimates gathered by CAPTRUST Research, directly from eight major product providers, February 2011.

[13] Brown, Jeffrey R. and Jeffrey R. King, Sendhil Mullainathan and Marian V. Wrobel. "Why Don't the People Insure Late Life Consumption? A Framing of the Under-Annuitization Puzzle."American Economic Review, vol 98(2), pages 304-309. May 2008.

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At CAPTRUST, we provide Plan Sponsors with independent advice across the retirement continuum, including plan design, fiduciary best practices, investment analysis, and participant advice.

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