DC Rising

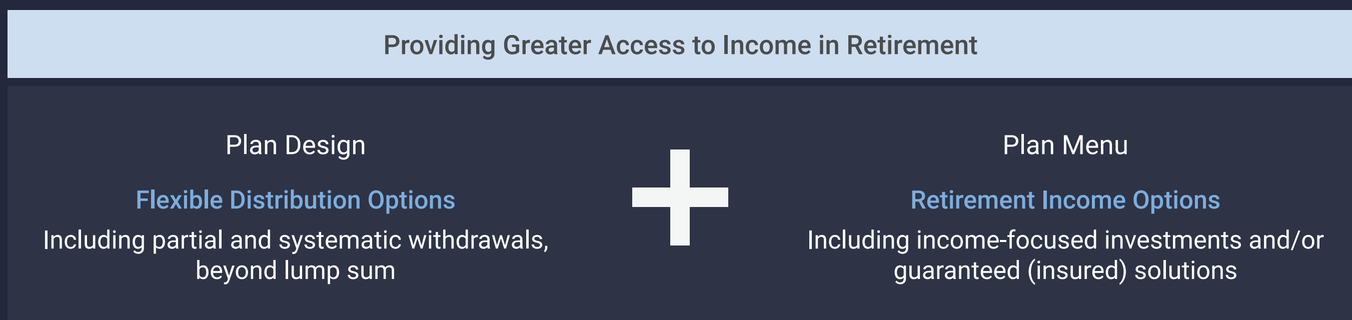
Turning Savings Into Retirement Income

A Range of Retirement Income Options for DC Plan Sponsors to Consider

LAZARD
ASSET MANAGEMENT

The sheer number of older Generation X and younger Baby Boomers approaching, or already in, retirement has quickly elevated the "retirement income" discussion among defined contribution (DC) plan sponsors: What—if any—plan changes should be made to help participants convert their DC plan savings into a sustainable source of income when they retire? The good news is that there is no one-size-fits-all approach. Rather, the plan's philosophy, preferences, and unique participant characteristics should help determine the scope of change.

Sponsors have two primary ways to evolve their plans to provide participants with greater access to their income in retirement: Expanding distribution options for increased flexibility and/or including income-focused options on the plan's investment menu (which can be put in place incrementally and don't have to be guaranteed). Regardless of the plan's ultimate strategy, it's important to start the conversation and document any key decisions along the way.



Here, we offer high-level insight into the plan design and plan menu options available to help participants transition their DC plan savings into retirement income. Sponsors, working with the plan's consultant or advisor, can consider using these insights to help determine the best income-oriented approach for the plan and its participants.

Contents

What's at Stake 4

Plan Design: Distribution Options 6

Plan Menu: Retirement Income Options 8

— Income-Focused Investments

— Dynamic QDIAs: The TDF Evolution

— Guaranteed (Insured) Solutions

Fiduciary Process Checklist 16

What's at Stake

Participants nearing retirement have two intertwined fears: Spending too much, too soon *and* outliving their savings. For most participants, managing "asset decumulation" in retirement is a daunting task requiring a complex set of forward-looking decisions that most are ill-prepared to make:[1]

- Before retiring, they're expected to estimate both their future income needs and available streams of income—and decide when they can truly afford to retire.
- Once retired, they're expected to not only manage their various income sources, but also to determine an appropriate withdrawal strategy from each over a period of 20–30+ years, keeping in mind inflation, longevity, and sequence-of-return risks.

Age	Retirement Confidence
35–44	54% ↓
45–54	40% ↓
55–64	39% ↓

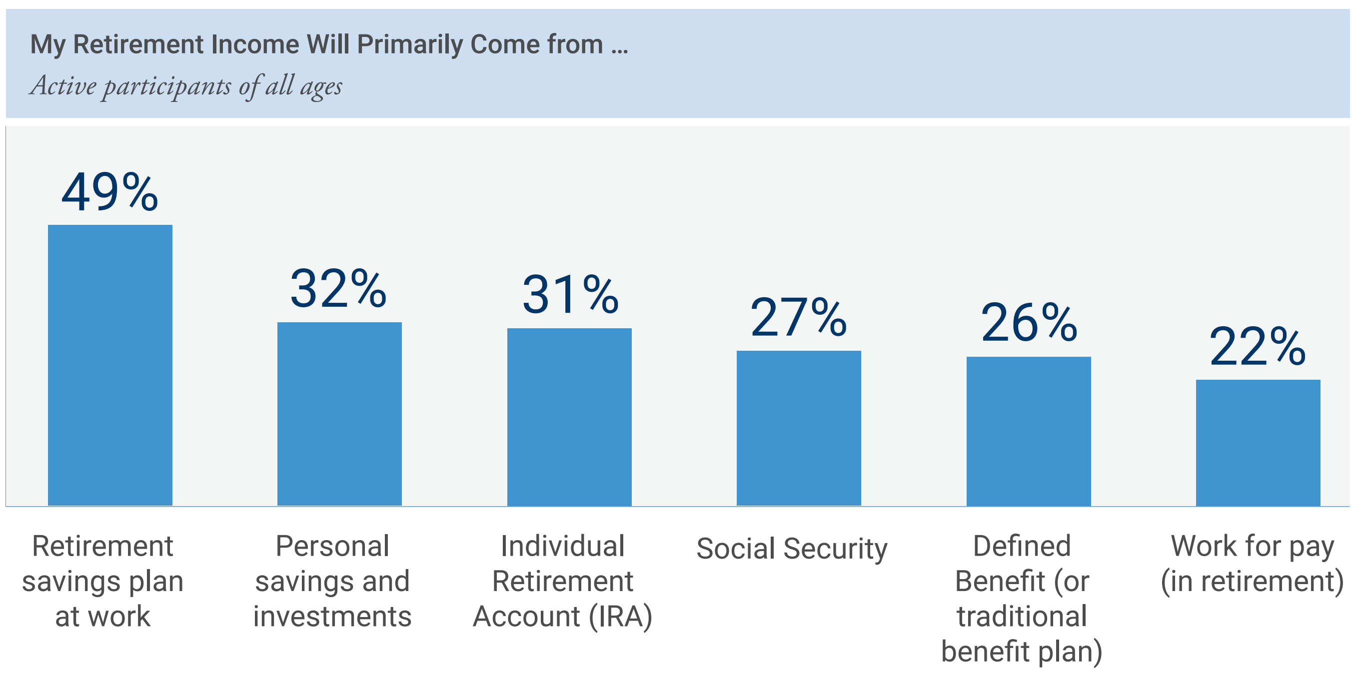
Source: Mercer, Inside Employees' Minds Study, 2022

It's no wonder that retirement confidence significantly declines—even as early as age 45—as retirement looms.[2] The result? An increasing number of workers ages 55 and older expect to push off retirement until ages 66–69, much later than they—and often their employers—would prefer.[3]

Major Retirement Income Sources

Employees have several potential sources of income to draw from when they retire; however, this varies greatly depending on many factors, such as their income and education levels, how much they've been able to save overall, if they're single, married, or divorced, and/or whether they've been working with a financial advisor.

While the potential sources may differ, many participants recognize that they're mostly on their own to fund their future. More than 4 in 5 workers expect their retirement savings plan at work to be a source of income in retirement, including 49% who say it will be a major source, followed by personal savings and investments.[4]



Source: Employee Benefit Research Institute, 32nd Annual Retirement Confidence Survey, 2022

63%

Assets owned by 401(k) participants over age 50.

With almost two-thirds of all 401(k) assets held by participants over age 50,[5] plan sponsors are in a unique position to help near retirees better prepare for—and positively transition into—their next life chapter.

Plan Design: Distribution Options

For years, plan sponsors focused on helping participants *save* for retirement with effective plan design initiatives—including auto features to combat inertia and boosting matching contributions to increase participation and savings rates. However, less attention has been paid to the ways that participants can access their accumulated retirement plan savings in retirement: While 95% of all plans offer a lump sum distribution, just two-thirds offer flexible ways for participants to access their savings.[6]

Withdrawal Types	Definition	Percentage of Plans Offering
Lump Sum (also known as full pay-out or full cash-out)	Lump sum payments can be paid as a rollover or as a full cash-out. This payout will typically close the account and participants will lose the fiduciary protection of sponsor.	95%
Flexible withdrawals include:		
Periodic/Partial Withdrawals	Periodic/partial withdrawals allow participants to specify an amount, or percentage of the account balance, to be distributed from the plan, usually on an **ad hoc** (as needed) basis. These withdrawals can be distributed as a rollover or as a cash-out.	66%
Systematic Withdrawals	Systematic (also known as installment or automatic) withdrawals allow participants to receive regular payments from their account at a frequency they request. Various options may be available via the plan's recordkeeper, including fixed dollar amount, fixed time frame, fixed percentage, life expectancy, or interest only.	64%

Source: DCIIA, Design Matters: The Retirement Tier Glossary of Terms, 2021; Plan Sponsor Council of America, 65th Annual Survey of Profit Sharing and 401(k) Plans, 2023

The decision to take a lump sum distribution is irreversible—assets moved out of the plan cannot move back in, and they lose the plan's fiduciary protection. It's a risky approach for participants, especially for those without external guidance: Roughly 20% of participants taking a lump sum distribution depleted those amounts rapidly—in five and a half years, on average.[7]

Sponsors should consider expanding the plan's distribution options to include partial withdrawals and/or periodic payment withdrawals to provide participants with maximum drawdown flexibility. Why? The reality is that once a participant retires:

55% leave some money in their plan account–even if they don't intend to stay in the plan long-term.[8]

20% leave almost their entire account balance in the plan—simply because they don't know what to do with it.[9]

Providing participants with more flexible ways to access their retirement plan savings in smaller increments, while they're formulating a sustainable strategy, can significantly improve their transition into retirement.

Sponsor Considerations

- Decide whether the plan wants to allow retired participants to make more flexible withdrawals from the plan. At the very least, consider partial withdrawals in addition to lump sum, even if sponsors prefer participants leave the plan. Sponsors may need to amend plan documents accordingly.
- Explore the distribution options available from your recordkeeper as well as others. These are often evolving and improving, and you may find additional options, some of which are easy to add.
- Evaluate the costs. Some recordkeepers may charge a nominal fee for partial and/or periodic withdrawals or may not facilitate investment-specific distributions (i.e. regular distributions from a specific participant holding).[10] Coordinate with the plan's recordkeeper to offer flexible, cost-efficient withdrawals.

Plan Menu: Retirement Income Options

Sponsors face increasing internal and external pressure to address the “retirement income” imperative. At a high level, the DC plan menu landscape is evolving to provide participants with:

- **Flexible income:** Income-focused investments with flexible distribution options,
- **Reliable income:** Guaranteed (insured) solutions with protected income payouts, or
- **A combination** of both flexible and reliable income options.

When offered through the plan, retirement income options provide participants with access to high-quality, cost-efficient solutions, along with fiduciary protection. However, it’s important for sponsors to remember that retirement income options can be put in place incrementally and don’t have to be guaranteed.

Evaluating investment changes to the plan takes time, so begin discussions in plan committee meetings with our DC Rising Plan Committee Playbook.

At a high level, the chart below shows a range of in-plan retirement income options sponsors can consider:

At a Glance: A Range of Retirement Income Options

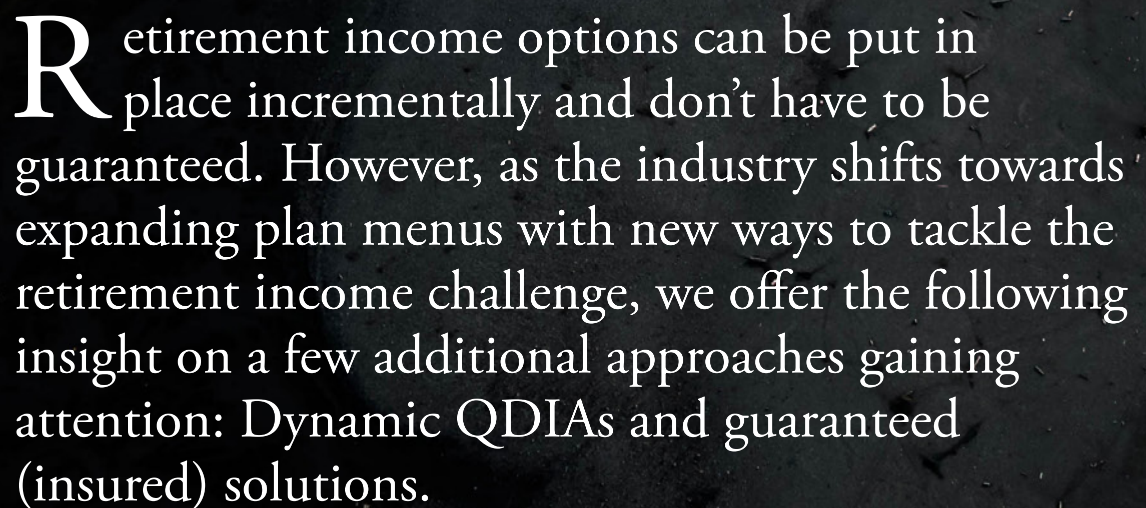
<table>
<tr><th colspan="2">Income-Focused Investments
Provides flexible income</th><th colspan="2">Guaranteed (Insured) Solutions
Provides reliable income</th></tr>
<tr><th>Income-Focused Investments</th><th>QDIA-Eligible</th><th>Fixed Annuity</th><th>Variable Annuity</th></tr>
<tr><td rowspan="2">• Stable value funds
• Managed payout funds
• Laddered/bond funds
• High dividend equity investments</td><td>• Target date funds (TDF)
• TDF series with multiple glidepaths
• Managed accounts
• Balanced funds</td><td>• Single premium immediate annuity (SPIA)
• Deferred income annuity (DIA); may include (optional) living benefit rider*
• Qualified longevity annuity contract (QLAC)</td><td>• Variable annuity with (optional) living benefit rider (e.g. GMWB)*</td></tr>
<tr><td colspan="3">Dynamic QDIA, often a TDF, which transitions some or all of a near-retiree’s account balance to:
• A managed payout service or fund within the TDF,
• An annuity allocation embedded in the TDF, or
• A separate managed account service</td></tr>
</table>

* Optional living benefit riders (for an additional fee) include a guaranteed minimum withdrawal benefit (GMWB), guaranteed minimum income benefit (GMIB), guaranteed lifetime withdrawal benefit (GLWB), or guaranteed minimum accumulation benefit (GMAB).

For illustrative purposes only. This chart should be considered a high-level overview only. Sponsors should consult the plan’s consultants/advisors.

Income-Focused Investments Offer Flexible Income

To start, there is a wide range of existing income-focused investments on many plan menus today. Examples include stable value funds, managed payout funds, laddered bond funds, and more. In addition, qualified default investment alternatives (QDIA)—such as target date funds (TDFs)—are widely implemented due to their automated nature. On their own, or through a managed account service offered by the plan, participants can combine these in-plan investments with outside assets (e.g. personal savings, spousal assets, Social Security, etc.) to create a flexible, diversified, and sustainable income stream in retirement.



Retirement income options can be put in place incrementally and don't have to be guaranteed. However, as the industry shifts towards expanding plan menus with new ways to tackle the retirement income challenge, we offer the following insight on a few additional approaches gaining attention: Dynamic QDIAs and guaranteed (insured) solutions.

Dynamic QDIAs: The TDF Evolution

With 92% of plans defaulting participants into TDFs,[11] sponsors are considering various ways to leverage these inertia-busting default vehicles to face the retirement income challenge head-on.

For example, Dynamic QDIAs (also known as Hybrid QDIAs)—a recent innovation in the DC space—are designed to potentially help older, higher balance participants navigate more complex financial circumstances as they near retirement.[12] They can also help sponsors retain participant assets in retirement, if desired.

How They Work

Generally, when a participant is 10–15 years out from their target retirement age, Dynamic QDIAs automatically transition some, or all, of their account balance to one of the following, as determined by the sponsor:

- A **managed payout** service or fund within the TDF.
- An **annuity allocation** embedded within the TDF.[13] This approach has numerous variations, but generally, these TDFs slowly allocate a portion to a fixed or variable annuity. Individuals are usually not "locked" into the annuity portion until they retire and can choose to elect to activate the payment stream from this feature.
- A separate **managed account service.**

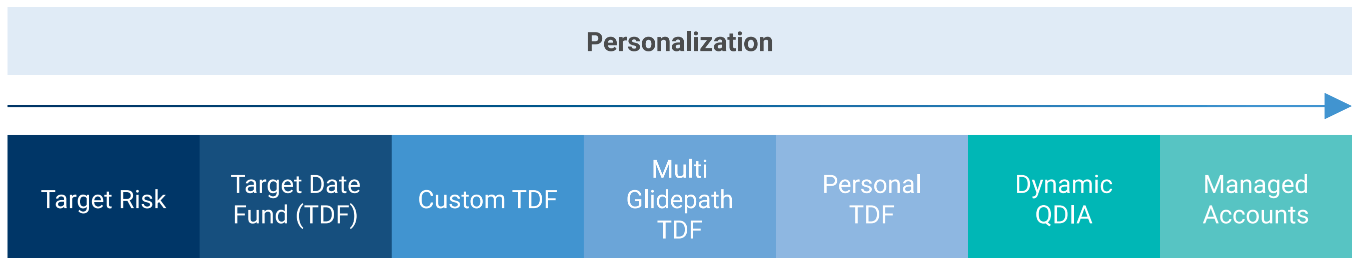
Depending upon the type of Dynamic QDIA chosen, the sponsor would then:

- **Set the threshold:** Usually, thresholds start around age 50, but can also include a set account balance or other criteria determined by the sponsor.
- **Determine opt-in or opt-out:** Under the QDIA safe harbor umbrella, sponsors can maintain the default into the "dynamic" transition option, eliminating the need for any participant decision-making. Or they could choose to offer the dynamic transition on an opt-in basis if they prefer to offer participants a choice.
- **Establish "dynamic" transition amount:** How much of a participant's account balance should transition? For example, moving 100% of their balance into a separate managed account service provides a more holistic view of their financial picture for proper customization, while allocating a portion (e.g. 15%–25%) into an embedded annuity option may be more realistic to provide participants with both flexible (income-focused investments) and reliable (guaranteed solutions) income.

Of course, there are many other considerations when considering Dynamic QDIAs, including costs, flexibility, portability, and fiduciary protection, especially when transitioning to annuities.

The Evolution of QDIAs: A Personalization Spectrum

Clearly, no two participants are alike: They differ across income levels, age, gender, plan savings balances, out-of-plan assets, access to spousal assets, financial literacy, personal preferences, and more. With advancing technology, sponsors and recordkeepers have increasing access to a deeper level of participant data and participant preferences. As a result, QDIAs have become more customized and/or personalized.



Source: Cerulli, US Monthly Product Trends Edition, September 2022

Guaranteed (Insured) Solutions Offer Reliable Income

Given participants' dual fear of spending too much, too soon, *and* outliving their savings, increasing attention is focused on offering access to in-plan guaranteed solutions via insurance-based annuities. The general idea is that participants could transfer some, or all, of their longevity and sequence-of-withdrawal risks to one or more insurance providers chosen by the plan. These guaranteed solutions can be used as a stand-alone option on the DC plan menu or embedded into a Dynamic QDIA, such as a TDF.

Guaranteed income is not a new retirement concept: Defined benefit (DB) pension plans and Social Security have been in existence for years. However, including annuities within the DC plan menu is relatively new, and comes with understandable sponsor concerns and considerations as the industry evolves.

In-Plan Annuities: How They Differ

Generally, annuities in the DC plan market today range across three types (fixed, fixed-index, or variable) with income payouts starting either immediately upon retirement or deferred to a later date.

The following chart is a high-level overview of annuity types available in DC plans today. While we're still in the early days of rapidly evolving product development, interested sponsors should work with the plan's consultant or advisor and ERISA attorney (as needed) to discuss the plan committee's approach to understanding in-plan annuities in general, and the specific details of current products available.

At a Glance: Three In-Plan Annuity Types

Lower complexity & cost ◄——► Higher complexity & cost

<table>
<tr><th rowspan="2">Type</th><th colspan="2">Fixed</th><th rowspan="2">Variable Annuity (VA) with Living Benefit Rider</th></tr>
<tr><th>Fixed Annuity (FA)</th><th>Fixed-Index Annuity (FIA)</th></tr>
<tr><td>Summary</td><td>Predictable, guaranteed income for life (or a certain period) with relatively low risk</td><td>Combines fixed annuity features with additional income potential from index-based investment growth</td><td>Combines variable annuity investment features with the option of guaranteed income for life</td></tr>
<tr><td rowspan="3">Benefits</td><td>• Offers a specific, guaranteed interest rate on contributions with set payouts for life[1]
• Fixed guaranteed payout amount is not impacted by market returns or inflation; FA interest rates tend to mirror bond interest rates; usually includes a standard death benefit
• Optional annual increase riders may be available for inflation protection, at an additional cost</td><td>• Offers a specific guaranteed interest rate on contributions with set payouts for life,[1] plus the potential for additional income based on a return pegged to any rise in the annuity's respective market index (e.g. S&P 500)
• The amount of participation in the index, however, is generally capped; if the index underperforms, participants still receive their guaranteed fixed payout amount</td><td>• Offers upside growth when markets rise (via underlying VA investments[1,2])
• In addition, when an optional living benefit rider is included—protects income during market corrections, while also providing guaranteed income for life</td></tr>
<tr><td></td><td colspan="2">Optional living benefit riders may be included (for an additional fee):
• Guaranteed lifetime income:
  • Guaranteed lifetime withdrawal benefit (GLWB)
  • Guaranteed minimum income benefit (GMIB)
• Principal protection (VA only):
  • Guaranteed minimum accumulation benefit (GMAB)</td></tr>
<tr><td colspan="3">Fixed and fixed-indexed annuities usually offer a standard death benefit. Optional enhanced death benefit riders may be offered (for an additional fee) to include (VA) or enhance (FA/FIA) principal and/or income protection for beneficiaries</td></tr>
<tr><td rowspan="2">Consider-ations</td><td>No potential for market growth</td><td>Guaranteed interest is generally lower than that credited by a fixed annuity, but potential returns are higher due to index-based crediting</td><td>Risk of loss of principal due to market losses, benchmark risk, and return dilution; optional riders may mitigate risk, for an additional cost</td></tr>
<tr><td colspan="3">Potential for early withdrawal charges (surrender charges)</td></tr>
</table>

Source: Insured Retirement Institute, The Retirement Saving and Income Handbook, 2023; DCIIA, Leading the Way: Defined Contribution Solutions Look for Yield for Retirement Income, November 2022; Investopedia, "An Overview of Annuities," April 2022

This chart should be considered a high-level overview only. Given the wide range of guaranteed products in the DC plan market, each may differ based on respective contract rules and provisions. Sponsors should work with the plan's consultant/advisor and ERISA attorney to review the detailed information of any guaranteed product under consideration.

1 Subject to the claims-paying ability of the insurance provider (issuer).

2 Unlike fixed and indexed annuities, a variable annuity is considered a security under federal law and is subject to regulation by the Securities and Exchange Commission (SEC) and FINRA.

The industry has emerged with various in-plan guaranteed product "flavors" along the annuity type and payout spectrum. However, depending upon the type of annuity chosen, risks may include:[14]

- The retiree does not have access to savings once income is initiated,
- There is generally less potential for a legacy,
- Retirement income isn't generally increased by favorable investment performance (if applicable), and
- Some annuities are also subject to the risk of inflation.

Many optional "living benefit" provisions (also known as riders) may be available to address some of these risks, but with offsetting costs or possible reduction in the guaranteed income promised, contract provisions and options should be reviewed closely.

The SECURE Act & Plan Sponsor Concerns

401(k) plan sponsors have been slow to adopt an insured component to their plan. While annuities have a long-standing history in 403(b) plans, just 13% of 401(k) sponsors said they were somewhat likely or very likely to add an annuity option to their plan in 2021.[15]

Understandably, questions regarding complexity, cost, and flexibility are becoming more specific as plan sponsors move towards making decisions about which guaranteed solutions—if any—to consider adding to their retirement plans. The Setting Every Community for Retirement Enhancement (SECURE) Act of 2019 sought to address sponsor concerns by providing:[16]

1. **A fiduciary safe harbor for the selection of insurance provider(s):** Under this provision, plan sponsors, as fiduciaries, would be relieved of liability for losses sustained by a participant due to an insurer's inability to pay the benefits under the guaranteed retirement income contract selected by the plan.

   To obtain the safe harbor, ERISA requires *only* that a committee obtain specified information from the insurance company and not have any information that would cause the committee to question the representations provided by the insurance company. *The safe harbor protection applies to the selection and monitoring of the insurer for such a contract, but not to the contract itself.*

   Plans with an annuity option in the plan prior to the SECURE Act would still need to do a new review to satisfy the safe harbor requirements.

2. **Guidance to assess "reasonable costs" for annuity contracts:** Even with the ability to negotiate lower institutional pricing, sponsors are understandably concerned about how potentially higher explicit/implicit costs, compared to non-guaranteed investment options, may impact the plan and its participants.

   The SECURE Act requires that a fiduciary needs to exercise care in selecting an insured solution to offer to their participants. While the safe harbor covers the selection of the insurance provider(s), plan sponsors are still obligated to consider that the costs (including fees and commissions) of the annuity contract(s) under consideration are reasonable, and should obtain relevant information to do so:

   - The benefits provided under the contract,
   - The features of the contract, and
   - The administrative services provided by the insurer under the contract.

3. **Increased portability for guaranteed income:** The SECURE Act enables participants to roll over any purchased annuity features to another DC plan or IRA. This gives plan sponsors the flexibility to remove these in-plan options while permitting participants to preserve their lifetime income investments and avoid surrender charges or penalties.

While the SECURE Act sought to address important plan sponsor concerns, there are still ongoing considerations, including:

- **A robust education effort:** Annuities are complex. They require a significant amount of education and communications to not only help participants understand how they work (and the guaranteed income they'll receive in retirement) but also to encourage uptake.
- **Participant interest:** Sponsors are naturally concerned about how many participants will take advantage of any DC plan menu offering, especially one that is complex. Adding to the concern is that annuities still have a negative stigma among younger Boomer and older Gen X participants from the past. Positively, younger participants do not have the same negative associations.
- **Opt-In or Opt-Out:** Dynamic QDIAs can automatically default participants into the guaranteed portion of the offering (e.g. Dynamic TDF) to combat participant inertia, with the ability to opt-out. However, sponsors must align this decision with the plan's philosophy, objectives, and participant demographics.

Fiduciary Process Checklist

When determining which retirement income options to add to the DC plan menu—whether non-guaranteed or guaranteed—it's important that plan committees stay in line with ERISA by following a proper fiduciary process. At a high level, this includes, but is not limited to, the following:[16]

- **Gather and review "prudent" information:** Committees must obtain and review the information that a "knowledgeable and prudent person" would want to review to make a particular (informed) decision.
- **Consider both cost and quality:** While the cost of a product or service—relative to competitive alternatives—is always important, there is not an obligation to select the lowest cost option. Instead, committees, acting as fiduciaries, should consider a wide range of factors including quality, features, ability of participants to understand and use the solutions, and restrictions or limitations associated with the solutions.
- **Follow fiduciary safe harbor requirements for guaranteed solutions:** The SECURE Act provides a fiduciary safe harbor for the selection and monitoring of the insurance provider(s), as well as a defined process for the selection of the contracts (e.g. annuities) they guarantee. The safe harbor protection applies to the selection and monitoring of the insurance provider for such a contract, but not to the contract itself. Plan sponsors are still obligated to consider whether the costs of the contract (in relation to the benefits, features, and administrative services offered) are reasonable.
- **Monitor decisions for prudence (ongoing):** Once decisions have been made and implemented, plan committees have an ongoing responsibility to monitor their decisions to determine if they continue to be prudent.

As a best practice—regardless of whether a plan committee decides to include specific retirement income options or not—it's important to document the committees' review process, due diligence, and decision rationale.

Summary

As a participant's DC plan will be one of their largest income sources in retirement, near-retirees are increasingly looking to sponsors for help in turning their accumulated savings into a flexible and sustainable stream of income for 20+ years. Accordingly, sponsors should begin evaluating and evolving their plans to address this looming retirement income challenge.

Together with the plan's consultant/advisor and recordkeeper, start the process by reviewing your current plan's approach to retirement income. As needed, expand distribution options to allow for greater income flexibility, and evaluate which retirement income options would best fit your plan's philosophy, participant demographics, and company resources. As always, as fiduciaries, plan committees should document its due diligence process and any decisions made.

DC Rising is the Lazard magazine for
the new retirement imperative.

DC*Rising*

For more information please contact your Retirement Plan
Advisor or Consultant, or visit us at

www.lazardassetmanagement.com/DCRising

Notes

1 CFA Institute Research Foundation, DC Plans: Challenges and Opportunities for Plan Sponsors, 2021

2 Mercer, Inside Employees' Minds Study, 2022

3 Employee Benefit Research Institute, 32nd Annual Retirement Confidence Survey, 2022

4 Ibid.

5 Jack Vanderhei, Sarah Holden, Luis Alonso, and Steven Bass, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2016," EBRI Issue Brief, No. 458, 10 September 2018

6 Plan Sponsor Council of America, 65th Annual Survey of Profit Sharing and 401(k) Plans, 2023

7 CFA Institute Research Foundation, DC Plans: Challenges and Opportunities for Plan Sponsors, 2021

8 Plan Sponsor Council of America, 64th Annual Survey of Profit Sharing and 401(k) Plans, 2022

9 Cerulli Associates, U.S. Retirement End Investor, 2022

10 Cerulli Associates, U.S. Defined Contribution Distribution, 2022

11 Callan Institute, Defined Contribution Trends Survey, 2022

12 Cerulli Associates, U.S. Defined Contribution Distribution, 2022

13 DCIIA, "Leading the Way: Defined Contribution Solutions Look for Yield for Retirement Income," November 2022

14 Institutional Retirement Income Council, "Exploring the Process of Adding an Income Solution to Your Retirement Plan," 2021

15 Callan Institute, Defined Contribution Trends Survey, 2022

16 Retirement Income Institute, "The Retirement Income Challenge in 401(k) Plans: Overcoming Legal Obstacles," Fred Reish and Bruce Ashton, January 2022

Important Information

Published on 12 September 2023.

Information and opinions presented have been obtained or derived from sources believed by Lazard to be reliable. Lazard makes no representation as to their accuracy or completeness. All opinions expressed herein are as of the published date and are subject to change.

Certain information contained herein constitutes "forward-looking statements" which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "target," "intent," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events may differ materially from those reflected or contemplated in such forward-looking statements.

This material is for informational purposes only. It is not intended as, and does not constitute, financial advice, fund management services, an offer of financial products or to enter into any contract or investment agreement in respect of any product offered by Lazard Asset Management and shall not be considered as an offer or solicitation with respect to any product, security, or service in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or unauthorized or otherwise restricted or prohibited. This article is intended for US audiences only.

The article is for general information only and is not intended to provide investment, tax or legal advice, or recommendations for any particular situation. The article reflects circumstances as of April 2023, and readers should be aware that subsequent developments may have affected the discussion and statements in the article. Please consult with a financial, tax, or legal advisor about your circumstances.

LRX614627