Insurance products issued by Minnesota Life Insurance Company and Securian Life Insurance Company

Defined Contribution Guaranteed Income

Learning from the Success of Pension Risk Transfer

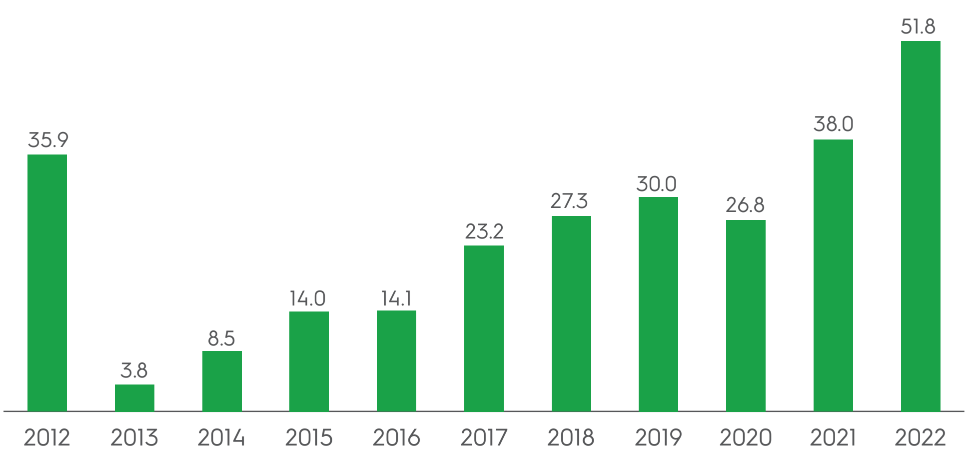
By Kent Peterson and Nick Volkmann

As one reflects on fiduciary responsibilities in the ERISA marketplace, it typically pays to keep it simple and to make sure the participant is getting a competitive price if they are footing the bill. It is also important to learn from adjacent markets that are having success to get some best practices. With increasing energy focused on guaranteed income solutions for defined contribution plans, there seems to be a growing emphasis on complex solutions for the simple problem of lifetime income and a lot of positioning as to why the complexity is necessary. As an alternative, let's keep it simple, create price competition within the plan, and learn from the pension risk transfer marketplace supporting defined benefit plans.

Pension risk transfer is a remarkable success story as the insurance industry continues to support corporate America and the retirement security of millions of defined benefit plan participants. While the risks of retiree longevity create diversification that strengthens insurance companies, the pension risk transfer transactions also improve the risk profile of corporate America as they remove longevity and investment risks from their balance sheets that are not core to the products and services of their business.

ANNUAL U.S. PENSION RISK TRANSFER MARKET

(Deal Volume: $ Billions)



Source: Mercer Quarterly Insurer Pension Risk Transfer Sales Survey and LIMRA annual market volume reports, 12/31/22

Over $250 billion of liabilities have moved from the defined benefit plans of corporate America to the balance sheets of insurance companies since 2012.[1] With $3.71 trillion of private sector defined benefit assets at the end of 2022,[2] this synergetic process will continue for decades to come.

Defined benefit plan sponsors are making a fiduciary decision when they do a pension risk transfer transaction with an insurance company. Beyond Section 404(a) of ERISA, the Department of Labor Interpretive Bulletin 95-1 provides fiduciary standards for selecting an annuity provider for a defined benefit pension plan.[3] Beyond getting a good price to settle the pension risk transfer transaction, DOL IB 95-1 states that the fiduciary "must take steps calculated to obtain the safest annuity available, unless under the circumstances it would be in the interests of the participants and beneficiaries to do otherwise." With over 20 insurance companies competing for pension risk transfer transactions,[2] there is ample opportunity to determine which of those insurance companies meet the safest annuity available criteria. Through a competitive bid process, the defined benefit plan sponsor gauges both price and safest annuity to make an informed fiduciary decision. If the process were to first pick a single insurance company and then solicit a bid, there is less incentive for the selected insurance company to provide their best price.

Sources of retiree income

For most current and future retirees, Social Security is a significant contributor to their retirement income security. The amount received from Social Security is based on the number of years in the work force and the taxable wages received in those years. The average Social Security benefit is just over $1,800 in 2023[4] and could be as large as $4,555 if a participant had earned the highest possible benefit and is delaying the start of the collection to age 70.[4] With the average Social Security benefit producing just short of $22,000 per year, it is just above the Federal Poverty Level, but it is not an income that meets the broad array of expenses confronting retirees.[5]

Beyond Social Security, workers can increase their retirement income through access to a defined benefit plan and/or defined contribution plan or an individual retirement account (IRA). If those tax qualified sources are not providing sufficient income, then individuals would need to draw on other assets that they have accumulated, such as their home equity and savings. The existence of a retirement plan or notable accumulated assets is necessary to support the retirees through their retirement years as Social Security is not intended to be the only source of income for retirees.

Changing environment from DB to DC

In November of 1978, the Revenue Act established Revenue Code Section 401(k) and the first 401(k) plan was created shortly thereafter. The concept of a 401(k) plan was further supported in 1981 when the Internal Revenue Service issued rules that allowed employees to contribute pre-tax salary deferrals into a 401(k) plan. From there, the 401(k) plan quickly became the predominant defined contribution plan approach for private employers to attract and retain employees.

In 1980, 38% of private industry wage and salary workers participated in defined benefit plans while 8% participated in defined contribution plans.[6] With private employers looking to lower their costs and financial risks, a dramatic shift occurred over the last four decades. The March 2023 Bureau of Labor Statistics indicated that only 10% of nonunion private industry wage and salary workers had access to a defined benefit plan while 68% had access to a defined contribution plan.[7] This dramatic shift underscores a concerning loss of retirement income security. Millions of Americans accustomed to living paycheck to paycheck in their working years are no longer destined to get guaranteed income from their defined benefit pension plan. Instead, retirees are confronted with a defined contribution balance that if not managed wisely will run out well before they (and their beneficiary) have passed away.

The first generation of workers entering the work force in their early 20s with a company 401(k) plan to fund their desired retirement will reach age 65 in the next few years. The remaining life expectancy for these 65-year-olds is approaching 20 years.[8] If the retiree and beneficiary are both considered, the remaining life expectancy of at least one of them can extend well beyond 20 years.

In 2019, Congress passed the transformative Setting Every Community Up for Retirement Enhancement (SECURE) Act which was signed by President Trump. While this legislation was broadly impactful to the retirement landscape, the portion focused on guaranteed income for defined contribution plans created the environment long-sought-after to achieve the much-needed transition from retirement savings to retirement income for the millions of defined contribution plan participants.

Impact of Section 203 of the SECURE Act - disclosure regarding lifetime income

The SECURE Act requires that defined contribution plans illustrate at least once annually the guaranteed lifetime income a participant and beneficiary would receive if the total accrued benefits of the participant were used to provide guaranteed lifetime income under prescribed assumptions for both a single life annuity and a qualified joint and survivor annuity.[9] The Department of Labor provided the assumptions and special rules for these illustrations in August of 2020.[10]

This illustration requirement and fiduciary protection, if assumptions and disclosures are properly applied, establishes important messaging to the defined contribution plan participants:

- an illustration of their purchasing power post-retirement and
- an ongoing reminder of their ability to continue to receive income in retirement as they have in their working years.

Only time will tell, but seeing their DC plan as income rather than an accumulated balance can dramatically change behaviors, both in how much is saved to maintain a standard of living and in the propensity to purchase guaranteed income at retirement.

With a small minority of future new retirees set to receive monthly income from defined benefit plans, the effective transition to defined contribution plans from defined benefit plans relies on defined contribution plan participants appreciating the risks of not obtaining a guaranteed income from their defined contribution plan assets. A single premium immediate annuity (SPIA) is consistent with the benefits once earned in defined benefit plans and will be the hallmark of the required disclosures for all defined contribution plans going forward. While other guaranteed income solutions are being created by recordkeepers and asset managers for defined contribution plans, simplicity, lower expenses, and understandability make SPIAs the likely preferred choice for retirees that are not high-net-worth individuals.

Impact of Section 109 of SECURE Act - portability of lifetime income options

In the years leading up to the SECURE Act, plan sponsors and lifetime income service providers were perplexed by limited portability since most lifetime income options were not transferable to a new recordkeeper if the plan sponsor determined it was fiduciarily prudent to change recordkeepers. Since the new recordkeeper could not provide ongoing recognition of the in-plan guaranteed lifetime income solutions, the plan sponsor was faced with a difficult decision on eliminating benefits that had paid historical fees. This conundrum kept plan sponsors from offering the guaranteed lifetime income solutions as it would create a fiduciary dilemma.

The SECURE Act created portability by permitting in-service distribution of the guaranteed lifetime income benefit through a qualified plan distribution annuity contract. This allows the participant to roll the guaranteed lifetime income benefit out of the plan into another qualified plan such as an individual retirement account (IRA). This needs to be done by the participant 90 days before the elimination of the guaranteed income product.

Interestingly, this portability solution creates plan leakage and a situation where the monitoring of the guaranteed lifetime income service provider previously done by the plan sponsor is transferred to the participant after the execution of an in-service distribution. It seems the fiduciary conundrum of portability is replaced by a different fiduciary conundrum as we think through the long-term aspects of participants' abilities to monitor their guaranteed lifetime income provider in a qualified plan distribution annuity contract without an advisor as is normally done in the high-net-worth marketplace that supports these products.

If SPIAs are the plan's selected guaranteed lifetime income solution, there is no need for a 90-day window for a participant to request an in-service distribution to a qualified plan distribution annuity contract. SPIAs are a point in time benefit - without historical fees creating a fiduciary dilemma. When a single premium annuity is selected by a defined contribution plan participant, the assets transfer to the insurance company to purchase the guaranteed lifetime income. Just as in the pension risk transfer transaction, the single premium immediate annuity is no longer in the plan.

Impact of Section 204 of SECURE Act - fiduciary safe harbor for selection of lifetime income provider

The fundamental aspect of all fiduciary decisions for a defined contribution plan relies on an objective, thorough and analytical search for and review of providers of service to the plan. Guaranteed lifetime income is no exception to that best practice.

In particular, the safe harbor for selection of a lifetime income provider rests on four requirements.

1. Considers the financial capability of such insurer to satisfy its obligations under the guaranteed retirement income contract (GRIC);
2. Considers the cost (including fees and commissions) of the GRIC offered by the insurer in relation to the benefits and product features of the contract and administrative services to be provided under such contract;
3. Concludes that at the time of selection, the insurer is financially capable of satisfying its obligations under the GRIC; and
4. Concludes that the relative cost of the selected GRIC is reasonable.

The essence of financial capability has historically been an uncomfortable position for a plan sponsor, so the rule has provided additional clarity that expressly defines this determination.

The requirements around cost are more interesting. There is NO REQUIREMENT TO SELECT LOWEST COST. The fiduciary decision can be made considering value generation like features and benefits in the contract as well as the financial strength of the insurance company relative to other options. In addition, a periodic review should be conducted to ensure that all the requirements continue to be met.

Depending on the type of lifetime income benefit, the plan sponsor will likely rely on an advisor to help evaluate and monitor a guaranteed lifetime income solution and its provider. Many plan sponsors will not have the internal experience to do that on their own and will want experts evaluating those solutions and the evolution of the options as the marketplace continues to expand and mature.

Who will assist the plan participants if they take an in-service withdrawal under Section 109 when a plan sponsor needs to cease offering a guaranteed lifetime income option that was prudent at the time of its removal? Is there still a need for a monitoring of its costs and financial capability of the insurance company on a regular basis? If not, why not?

Positive attributes of single premium immediate annuity

The single premium immediate annuity has a lot of strengths and positive attributes to both the plan sponsor and the plan participant as a defined contribution plan's guaranteed lifetime income solution.

- It is consistent with the annual disclosures that they will get that translates their defined contribution assets into lifetime income;
- It is very similar to the Social Security benefit that also will be received which furthers its understandability;
- It has positively supported millions of defined benefit plan participants in their retirement years;
- It is a point in time benefit, so participants don't pay for something years in advance of the decision on whether or not they actually want to use it for guaranteed lifetime income after retirement;
- It does not create plan leakage for active employees; and
- It does not put employees in a position of having to monitor a lifetime income solution or, worse, that the employee does not monitor and the solution becomes less cost-effective or the insurance company has reduced financial capability.

Plan sponsor considerations in offering single premium annuities

For the plan sponsors that choose single premium income annuities as their plan's guaranteed lifetime income solution, there is an opportunity to learn a best practice from the pension risk transfer decisions made by defined benefit plan sponsors.

Group annuity contracts supporting single premium income annuities are used for both a defined benefit plan pension risk transfer transaction and guaranteed lifetime income solutions for a defined contribution plan. In either case, the plan sponsor needs to evaluate and determine that the financial strength of the insurance company is appropriate to meet the long-term obligations of single premium income annuities on behalf of the best interests of the plan participants.

Where the defined contribution plan sponsor can fall short is on not getting a competitive price for their plan participants. This is where competition is vital, and why the pension risk transfer market has been so successful for defined benefit plans. There is no requirement that a defined contribution plan only offer one insurance company to support single premium income annuities. In fact, current technology exists for multiple insurance companies to be selected by the plan sponsor that are financially capable of meeting the obligations of single premium income annuities for their plan participants. When a plan participant wants to request a quote, they get a quote from multiple insurance companies that all have signed group annuity contracts with the plan sponsor. The insurance companies are incentivized to give their best price, and the participant is ensured that they are getting the most out of their retirement savings.

Conclusion

The first generation of employees who have saved their entire careers in 401(k) plans are reaching retirement. Social Security will not adequately meet their retirement income needs on its own, so most new retirees will need to efficiently transact some portion of their defined contribution assets to lifetime income. If a competitive bid process by financially strong insurance companies is employed on single premium income annuities, the plan sponsor employs a straightforward fiduciary practice to meet the best interest of their plan participants for years to come. Sure, the insurance companies would prefer to not compete on each bid, but the pension risk transfer market has proven that they will compete if they have to.

Kent Peterson, CFA, FSA, MAAA, AIF®, is vice president for Institutional Retirement Solutions at Securian Financial.

Nick Volkman, CFA, FSA, MAAA, CERA, is actuarial director and chief financial officer for Institutional Retirement Solutions at Securian Financial.

1. **Defined Benefit Pension Risk Transfer 2022** (mercer.com), as of March 2023
2. **U.S. Retirement Assets: Data in Brief** (congress.gov), as of September 2023
3. **CFR-2022-title29-vol9-sec2509-95-1.pdf** (govinfo.gov), as of August 2023
4. **The Maximum Social Security Benefit Explained** (aarp.org), as of May 2023
5. **KA-01903 · FAQ I SSA** (ssa.gov), as of January 2023
6. **The Disappearing Defined Benefit Pension and Its Potential Impact on the Retirement Incomes of Baby Boomers** (ssa.gov), as of October 2009
7. **EBS Latest Numbers : U.S. Bureau of Labor Statistics** (bls.gov), as of September 2023
8. **Actuarial Life Table** (ssa.gov), as of January 2023
9. **PUBL094.PS** (congress.gov), as of December 2019
10. **Pension Benefit Statements - Lifetime Income Illustrations I U.S. Department of Labor** (dol.gov), as of August 2020

Securian FINANCIAL®

PREPARE
PROTECT
SECURE

securian.com

400 Robert Street North, St. Paul, MN 55101-2098

F105251 11-2023 DOFU 11-2023
3176251