TIAA CREF Financial Services

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Retirement Income Solutions For Governmental Defined Contribution and Deferred Compensation Plans

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Please note that Roderick Crane is not practicing law as an attorney and is not providing tax or legal advice. Such advice should come from your own tax or legal advisors.

Guaranteed Lifetime Income?

Sometimes it feels like a life or death question

Discussion Agenda

- When should adding a lifetime income solution to your plan be considered?
- What solutions should be considered?
  - Non-product solutions: periodic payments, managed payouts
  - Product solutions: annuities, GMWBs (Guaranteed Minimum Withdrawal Benefit), imbedded annuities
- What legal and fiduciary issues should be considered?
  - State and federal regulation and compliance
  - In-plan vs. out-of-plan solutions
  - Prudence and due diligence processes

When should a lifetime income solution be considered?

- **Quiz – True or False**

Individuals should plan to have enough retirement income to last their life expectancy.

False

50% of people will live past the average life expectancy.

Source: Society of Actuaries, Simple Life Expectancy Calculator http://www.soa.org/research/software-tools/research-simple-life-calculator.aspx . April 2013

People are living longer

Women	
(Life Expectancy at Age 65: 20.4 years)	
Probability of Surviving to Age	
75	83%
80	71%
85	54%
90	34%
95	16%

Men	
(Life Expectancy at Age 65: 17.6 years)	
Probability of Surviving to Age	
75	77%
80	61%
85	41%
90	22%
95	8%

Source: Society of Actuaries, Simple Life Expectancy Calculator http://www.soa.org/research/software-tools/research-simple-life-calculator.aspx . April 2013

When should a lifetime income solution be considered?

- **Quiz – True or False**

  Public employees have enough guaranteed retirement income through their defined benefit plans and Social Security.

True for some, but perhaps not for all

When should a lifetime income solution be considered?

Public Employees Are Not All The Same

- Sources of guaranteed lifetime income vary widely
  - Defined benefit pension
  - Defined contribution (sometimes)
  - Retiree health plan/health insurance benefit
  - Social Security
- Length and period of public service varies
  - Public employee average tenure: 7.8 years*
- Not everyone retires at Social Security Retirement Age

*Bureau of Labor Statistics. http://www.bls.gov/news.release/pdf/tenure.pdf. September 2012

When should a lifetime income solution be considered?

- **Quiz – True or False**

Individuals tend to make appropriate guaranteed income choices.

False

When should a lifetime income solution be considered?

Participants tend not to choose guaranteed income <u>regardless of need</u>*

- Most people underestimate how long they will live
- Framing is a factor: consumption vs. investment
- Fear of loss of asset liquidity/legacy assets
- Product complexity is a problem
  - Cost, product variations, insurer financial strength, portability
  - Death benefits, inflation protection, minimum guarantees, etc.

* *Why don't the people insure late life consumption? A framing explanation of the under-annuitization puzzle*. TIAA-CREF Institute: Research Dialogue. April 2008

When should a lifetime income solution be considered?

- **Quiz – True or False**

Retirement financial risks are increasing for individuals.

True

When should a lifetime income solution be considered?

- Longevity risk is increasing
- DB pension and retiree health reforms
  - Changes in DB plan formulas resulting in lower benefits
  - Decreased in number of overall DB plans being offered
- Social Security and Medicare
  - Higher retirement ages, smaller COLAs, reductions in health coverage
- New Normal Financial Markets
  - Lower returns
  - Higher volatility
- Inflation looming?

When should a lifetime income solution be considered?

A lifetime income solution should be considered if:

- Employees need it
- It is consistent with benefits and workforce policy objectives of the plan sponsor

Barriers to action

- Historical focus on wealth accumulation vs. retirement income
- Plan sponsor paternalism vs. libertarianism
- Product complexity and participant behavior barriers
- Increased administration burden
- Fiduciary risk management
- No ERISA safe harbor

What solutions should be considered?

Non-product solutions:

- Periodic payments – installments paid over a period elected by the participant (e.g., 10, 20, 30 years)
- Fixed dollar amount payments – installments in a specific dollar amount
- Life expectancy payments – installments based on life expectancy of the individual
- Managed payout services – advisor-assisted distribution strategy

Advantages:

✓Easier to understand

✓Greater flexibility to start, stop, modify

✓Less costly

Disadvantages:

✓Risk of running out of money

✓Managed payout/account fees

What solutions should be considered?

Product solutions: Fixed Annuities

- Can create a stream of period payments that will last the individual's lifetime
- Many options: e.g., survivor benefits, minimum period, inflation protection

Advantages:

✓Addresses longevity risk

✓Partial annuitization flexiblity – not an all-or-nothing proposition

✓Higher income than GMWB

Disadvantages:

✓More costly – mortality and expense fees

✓Less flexible in dealing with changing circumstances

✓Products can be complex and hard to understand

✓Risk of loss of principal – i.e., dying before return of purchase price

✓Liquidity and portability limitations

What solutions should be considered?

Product solutions: Variable Annuities

- Lifetime payments can be selected that will vary with investment performance of the product
  - Product options: e.g., survivor benefits, minimum period, inflation protection

Advantages:

✓Addresses longevity risk

✓Partial annuitization flexiblity – not an all-or-nothing proposition

✓Inflation hedge possibility

✓Higher income than GMWB

Disadvantages:

✓Income amount not guaranteed – can go up or down

✓More costly – mortality and expense fees

✓Less flexible in dealing with changing circumstances

✓Products can be complex and hard to understand

✓Risk of loss of principal – i.e., dying before return of purchase price

✓Liquidity and portability restrictions

What solutions should be considered?

Product solutions: GMWB

- Guaranteed Minimum Withdrawal Benefit – provides an income guarantee coupled with full access to market value of participant's account
  - The income base, once activated, cannot decline due to market performance
  - Example: Income guarantee of 5% of "income base" value paid annually for life
  - 5% x $100,000 income base = $5,000 annual benefit
  - Product options: e.g., lump sum and survivor benefits, income base "step up" rules

Advantages:

✓ Addresses longevity risk and market downturn protection

✓ More flexible – not an all-or-nothing proposition, full access to account value

✓ Inflation hedge possibility

Disadvantages:

✓ Lower guaranteed amounts/more costly – mortality, market and expense fees between 100-125 basis points*

✓ Loss of guarantee if higher withdrawals are needed

✓ Products can be complex and hard to understand

✓ Liquidity and portability restrictions

Retirement income strategies or retirement savings plans are not just about saving anymore, National Association of Governmental Defined Contribution Administrators Issue Brief, July, 2013

What solutions should be considered?

- Product solutions: <u>Imbedded Annuities</u>
  - Group fixed or variable annuity solution wrapping a set of target date or asset allocation funds provides an income guarantee coupled with full access to market value of participant's account
    - Many product options and variations: e.g., survivor benefits, income base "step up" rules

<u>Advantages</u>:

✓Addresses longevity risk

✓More flexible – not an all-or-nothing proposition, full access to account value

✓Inflation hedge possibility

✓Group annuity is less costly than GMWB

<u>Disadvantages</u>:

✓Amount of retirement income varies by wrap product

✓Products can be complex and hard to understand

✓Liquidity and portability restrictions on employer

✓No market risk protection during accumulation period

Retirement income strategies or retirement savings plans are not just about saving anymore, National Association of Governmental Defined Contribution Administrators Issue Brief, July, 2013

What legal and fiduciary issues should be considered?

Plan Level Legal Requirements

- Authorizing state and local laws
- Plan and trust documents
- Questions:
  - Are guaranteed products permitted?
  - Are statutory or plan amendments needed?

What legal and fiduciary issues should be considered?

Legal and Regulatory Environment For Income Products

- State Insurance laws and regulations
- Federal Securities regulation (SEC)
- FINRA regulation
- State Guaranty Association protections
- Federal and State tax laws
- Fiduciary laws
  - State laws (direct)
  - ERISA (indirect)

What legal and fiduciary issues should be considered?

- Credit/Counterparty Risk
  - Insurer solvency
    - e.g., Executive Life, Mutual Benefit Life failures
  - The fiduciary question: Is it prudent to rely on the financial strength of the company backing the annuity promise?
- Product fit to plan objectives
  - Portability
  - Fees/costs
  - Transparency
  - Fit of product to plan objectives
  - Flexibility for participant
  - Inflation protection features
  - Survivor benefits and other product features

What legal and fiduciary issues should be considered?

Fiduciary Standards

- Fiduciary obligations arise when the guaranteed retirement income solution is provided “in the plan”
- No fiduciary obligation for:
  - “Out of plan” solutions:
    - Rollouts to an IRA and participant chooses a retail product
    - Annuity shopping services
  - Not offering a solution unless required by law or by the plan document

What legal and fiduciary issues should be considered?

Fiduciary Standards For “In Plan” Solutions

- Fiduciary standards vary from state to state
  - Prudent man
  - Prudent person
  - Prudent expert
- Important to get legal advice
- ERISA is not applicable but very useful for understanding what a prudent process might be

What legal and fiduciary issues should be considered?

Department of Labor Guidance

Prudence guidance on selection of annuities has changed over the years

- 1995 DOL Interpretive Bulletin 95-1
  - Safest available annuity
- 2006 Pension Protection Act and 2008 DOL Final Safe Harbor Regulation §2550.404a-4

What legal and fiduciary issues should be considered?

2006 Pension Protection Act and 2008 DOL Final Safe Harbor Regulation §2550.404a-4

Fiduciary duties:

- Conduct an objective, thorough and analytical search when selecting providers from which to purchase annuities
  - If necessary, the plan fiduciaries should consult with appropriate experts
- Consider information sufficient to assess the ability of the insurer to make all future payments under the product
- Consider the cost (including fees and commissions) of the product in relation to the benefits and administrative services to be provided
- Conclude that, at the time of the selection, the insurer is financially able to make all future payments under the contract and its cost is reasonable in relation to the benefits and services to be provided under the contract

What legal and fiduciary issues should be considered?

Assessing the Financial Strength of an Insurer

- The insurer's experience and expertise in providing the desired product's features
- The insurer's capitalization, surplus and reserve status
- The insurer's credit ratings by insurance rating services
- The flexibility of the contract terms
- The scope of additional protection through state guaranty associations

What legal and fiduciary issues should be considered?

Measuring Financial Strength

- Examine the company's current and history of financial strength:
  - Credit ratings
    - Fitch, Moody's, Standard & Poor's, Best's
  - Risk-Based Capital (RBC) position
    - 100% RBC is usually the minimum
    - Highest credit ratings require 300% RBC or higher
  - Publicly available financial and actuarial reports
  - Capital position and contingency reserves

What legal and fiduciary issues should be considered?

Investment Performance and Cost of the Product

- Fixed products crediting rates
- Variable products investment performance
- Fees
  - Commissions, surrender fees, loads
  - Mortality and Expense fees (M&E)
  - Interest rate spreads
  - Other
- Transparency of fees is a consideration

Summary

- Assess the need for a retirement income solution
- Examine all your product and non-product solutions
- Know your legal and fiduciary environment
- Get help from experts
- Understand the selection and monitoring of guaranteed income products and providers is similar but more complicated than other investments
- A prudent process is vital

Guaranteed Lifetime Income?
It's not really a life or death decision

To annuitize, or not to annuitize:

that is the question…

Guaranteed Lifetime Income?
It's not really a life or death decision

To annuitize, or not to annuitize: that is the question:

To secure: perchance to dream: ay, there's the rub;

For in that guarantee what legacy asset dreams may be lost

If we have too soon shuffled off this mortal coil,

Must give us pause: there's the insurance wager

That makes financial calamity of too short a life;

And what plan sponsor would bear the whips and scorns of liability,

The fiduciary's error, the lawyers' lash and

The pangs of failed prudence, the law's penalty imposed on lack of due diligence; Oh, that dread of "in plan" solutions;

Annuitization - the undiscover'd country from where

No fiduciary returns, that puzzles the consultant

And makes us rather bear those retirement security ills we have

Than fly to others that we know not of.

And I ask: Will fiduciary risk make cowards of us all?

- With apologies to the Bard

Source: Roderick Crane of TIAA-CREF

Appendix

State Regulation of Guaranteed Retirement Income Products

State Insurance Laws and Regulations

Annuities and GMWBs are insurance products issued by life insurance companies. The individual states have regulatory authority over life insurance companies domiciled within their borders. For an annuity or GMWB to be distributed, it must meet the requirements imposed by the states, which include suitability guidelines with which distributors must adhere in their sales practices. In some states, there is an extra layer of consumer protection guidelines, e.g., those that apply to the sale of such products to senior citizens. The states also regulate the life insurance companies by setting reserve and other financial requirements and standards.

State Regulation of Guaranteed Retirement Income Products

State Guaranty Association Protections

All 50 states, the District of Columbia and Puerto Rico have guaranty associations that protect policyholders, up to specified limits, in the event that an insurance company becomes insolvent. State guaranty associations are created and governed under state law and thus there is some variation among states in the operation of their respective guaranty associations; most guaranty associations cover up to at least $100,000 in present value for annuity benefits.

Generally, where the policyholder lives at the time of the insurance company's insolvency determines which state guaranty association is applicable. If a member insurer becomes insolvent, funds to continue coverage and/or pay claims are raised through assessments of the state guaranty association's other member insurers.

Federal Regulation of Guaranteed Retirement Income Products

Federal Securities Regulation (SEC)

Variable and indexed annuity products, and GMWB products, are considered to be securities subject to federal securities laws because the underlying assets are invested in the equity markets. SEC regulations may require such products comply with product registration and disclosure rules, and be issued with a prospectus that details expenses, charges and risk.

Federal Regulation of Guaranteed Retirement Income Products

FINRA Regulation

The Financial Industry Regulatory Authority (FINRA) is a self-regulatory body that regulates business practices and sales conduct of all licensed representatives. The rules of conduct established by FINRA must be followed when marketing and selling variable and indexed annuities. Strict requirements for suitability must be met when a variable or indexed annuity is sold.

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