Protected retirement income solutions

What plan sponsors need to know about a new generation of offerings

Building a better working world

Employers are increasingly looking for ways to support their employees' financial security throughout retirement. For plan sponsors and consultants considering the full range of options, this paper will evaluate how the latest generation of protected retirement income (PRI) solutions can fit into overall plan design. Many of these products, which have evolved considerably in the decades since their initial launch, now offer significant benefits to both plan sponsors and participants.

Previous iterations of PRI products were not widely adopted due to the perception that they were too complex and offered only limited benefits. The PRI solutions on the market today have been redesigned to address many of the common challenges that face employers and employees. Specifically, our research and analysis confirm that the latest generation of these solutions frequently offer better outcomes compared to traditional products such as target-date funds (TDFs), increased portability and more flexibility.

This paper will explore common misconceptions about protected retirement income solutions and how today's offerings vary from those of the past. It also provides highlights and insights from our quantitative analysis of one common type of in-plan PRI solution. Lastly, it outlines the value proposition for plan sponsors, which is based largely on better outcomes for employees, employer cost savings and increased plan asset retention.

Our research findings suggest that PRI solutions are likely to gain traction in the market as the benefits become clearer to plan sponsors and other stakeholders. Insurers and benefits providers should be aware, however, of the need for clear communications and advocacy as they seek to address various barriers to adoption. They will also need to be aware of issues related to transparency, adjacent services (e.g., wealth management) and the comparability of solutions.

About our research

In September–November 2023, EY researchers undertook a multidisciplinary market survey, combining secondary (evaluation of 27 industry reports) and primary research (interviews with 14 subject-matter resources and industry stakeholders). Our research and conversations revealed common misconceptions about and concerns with PRI solutions. To quantify the potential benefits for plan sponsors, EY actuaries conducted three distinct analyses based on Monte Carlo simulations.

The emergence of a new generation of protected retirement income solutions

Protected retirement income solutions have existed in some form for more than a century. The first in-plan annuities were offered in 1918 and changed very little over time.[1] In the last few decades, they began to evolve, driven largely by market demand for more transparency and lower fees. The most significant difference is that today's offerings combine fund and insurance innovation.

The first generation of these products was not portable or liquid and typically featured a single asset class, annuity contracts. TDFs offered in defined contribution (DC) plans provided access to mutual funds, with basic asset allocation of stocks and bonds guided by a standard target date for withdrawal or the beginning of decumulation.

Starting in 2006, the second generation of PRI products combined TDFs and annuities to offer access to index funds and a glide path based on workers' retirement timelines. They did not solve for portability or liquidity, however. A new class of TDFs and managed drawdown funds employing mutual funds and collective investment trusts (CITs) aimed to do just that. However, without guarantees, income could fluctuate.

Today's PRI products combine CITs and TDFs with guarantees. Typically, participants have access to a range of underlying index funds (e.g., the S&P 500 Index Fund, US Aggregate Bond Index Fund). They are both portable and liquid and are not proprietary to individual recordkeepers.

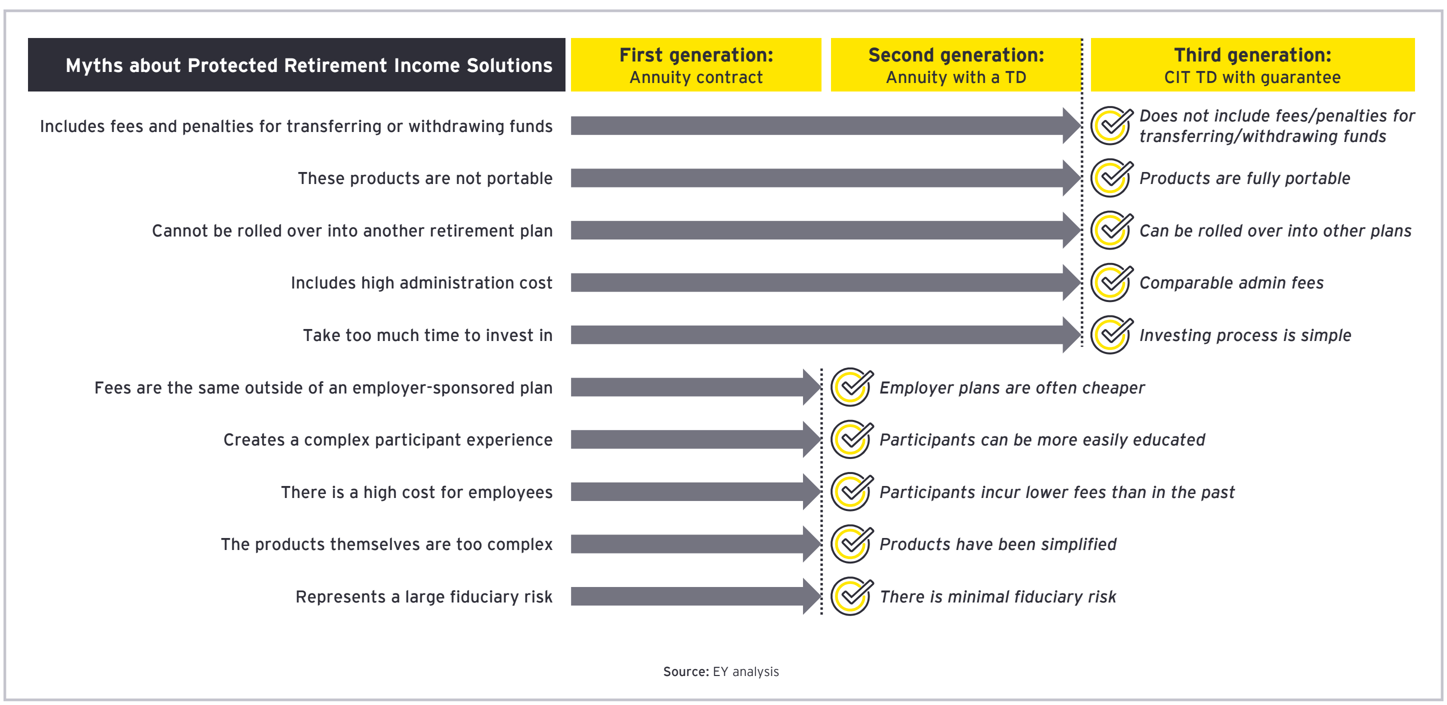
Common misconceptions and persistent myths

Despite these significant enhancements, misconceptions persist about the value and efficacy of PRI solutions. According to our research, many stakeholders, including experienced industry professionals, associate PRI solutions with:

- Participant fees or penalties to transfer or withdraw funds
- Fiduciary risk for the plan sponsor
- Lack of portability of funds for the participant
- High administration costs for the plan sponsor
- Solution complexity for the participant

The reality is that most of the protected retirement income products on the market today have been designed to address these issues. *See Figure 1*. They are portable, can be rolled into other types of plans and do not compromise plan sponsors' and advisors' fiduciary duties. Fees and penalties for withdrawal and transfer have been eliminated or reduced. The costs for employers, including administrative costs, are often lower than they were previously. Concerns about complex enrollment and investment processes for participants can be addressed with effective communication plans.

Figure 1: Today's protected retirement income solutions are designed to address common buyer objections of the past



Source: EY analysis

[1]https://www.tiaa.org/public/pdf/t/TT_FAQ.pdf

Plan consultants have additional concerns related to the criteria they use to recommend products to employers. For example, in our research, many referenced a belief that these products are not suitable for individuals with lower account balances. They also referenced the fear of changes to existing solutions and recommending solutions that few, if any, companies have adopted. The loss of potential wealth management clients and limited transparency due to the lack of a common data set were other concerns.

Again, our research makes clear that the latest version of PRI solutions largely addresses many common concerns. However, the industry must address the lack of a common data set and navigate potential impacts on the wealth management business. As some of our survey respondents noted (see sidebar), these issues must be addressed if PRI solutions are ever to achieve widespread adoption.

What stakeholders say:

“Information on these products is hard to find and compare.

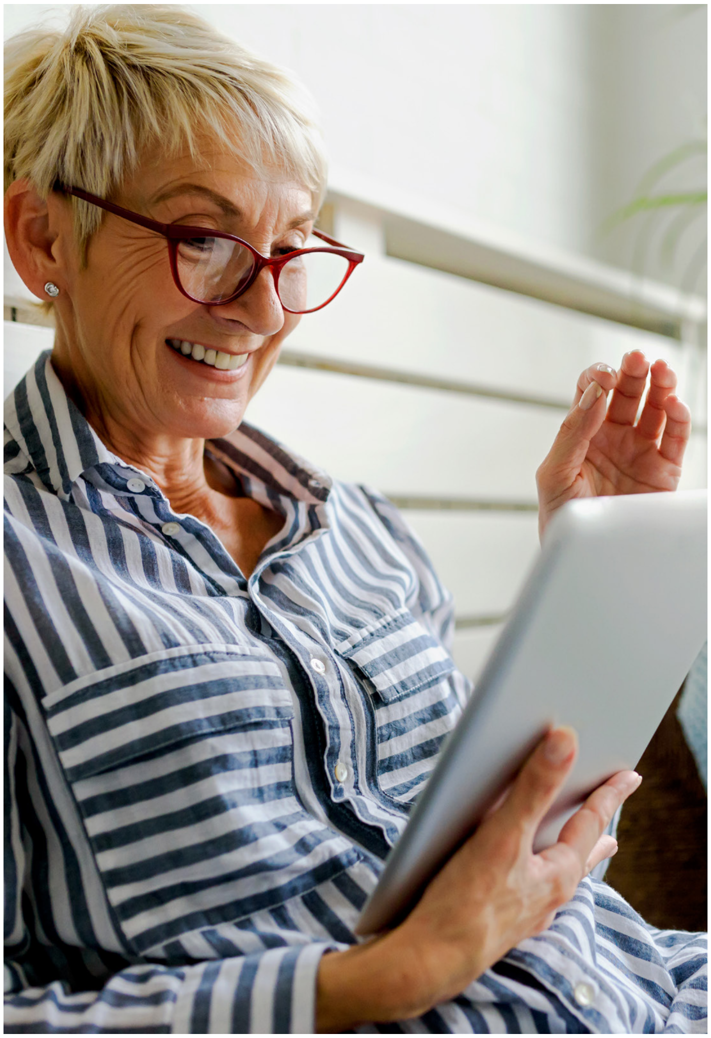
Former senior VP financial advisor, retirement advisory firm

“I want to see performance and the associated administrative fees. And if you don’t have really good data to back up your decisions, you get exposed fairly quickly.

Former senior VP of human resources, consumer goods firm

“Is this going to be a viable solution over the long haul?

Senior VP financial advisor, retirement investment consulting firm



Validating the performance of PRI solutions

The objective of our research was to validate the ability of PRI solutions to deliver essential income under multiple retirement scenarios and in comparison to TDFs under multiple draw-down percentages. Specifically, we explored how they can produce adequate income to cover essential expenses (e.g., housing, food, health care, transportation, personal insurance) during retirement.

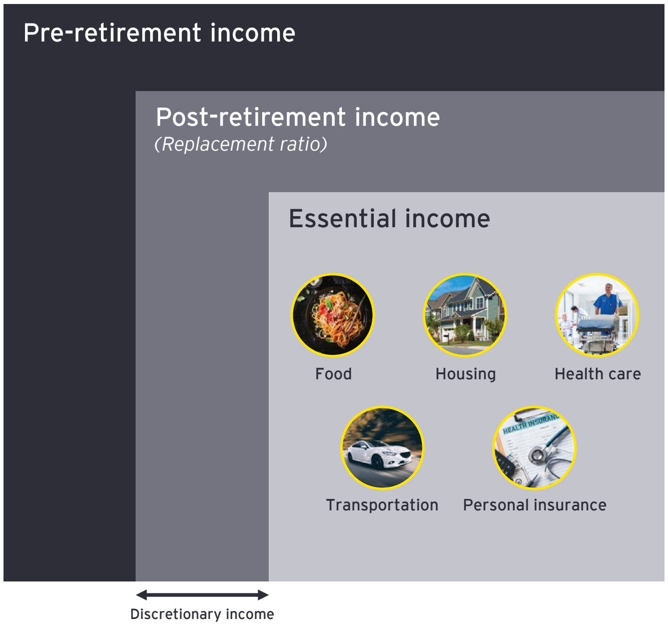
For the sake of our analysis, we used the following assumptions:

- Pre-retirement income: Income individuals have access to prior to retirement via employment, contracted work or other gains.
- Post-retirement income (replacement ratio): Amount of income needed in retirement to cover discretionary and non-discretionary expenses; the industry average suggests that ~80% of pre-retirement income is needed in retirement.
- Essential income: Income needed in retirement to cover essential expenses (i.e., non-discretionary expenses); this often accounts for a large portion of income needed post-retirement, approximately 65% of pre-retirement income (1).

Source: Consumer Expenditure Surveys, 2021–2022; EY analysis

See Figure 2.

Figure 2: Essential income needs range from 75% to 85% of post-retirement income; this is approximately 65% of pre-retirement income, on average



Pre-retirement income: Represents income individuals have access to prior to retirement via employment, contracted work or other gains.

Post-retirement income (replacement ratio): Amount of income needed in retirement to cover discretionary and non-discretionary expenses; the industry average suggests that ~**80%** of pre-retirement income is needed in retirement.

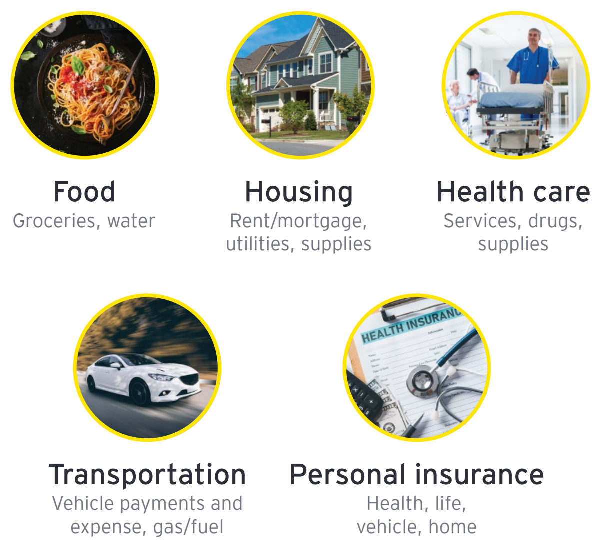
Essential income: Income needed in retirement to cover essential expenses (i.e., non-discretionary expenses); this often accounts for a large portion of income needed post-retirement, about **60% to 67%** of pre-retirement income.[1]

Ensuring a secure retirement requires managing significant risks, including the need to have adequate funds to cover essential expenses during retirement. In-plan guaranteed income solutions can help cover these expenses.

[1]Source: Consumer Expenditure Surveys, 2021-2022; EY analysis

Essential income needs range from 73% to 85% of post-retirement income; this is ~ 65% of pre-retirement income, on average

Essential income categories



Key assumptions

*Assuming a replacement ratio of **80%**, essential income represents an average of **65%** of pre-retirement income.*

Median income population

Age band	Median salary	Median balance	Median annual contribution %
20-29	$40k	$15k	6%
30-39	$53k	$55k	7%
40-49	$56k	$125k	7.5%
50-59	$62k	$175k	8%

Higher income population (9th decile)

Age band	Median salary	Median balance	Median annual contribution %
20-29	$82k	$24k	6%
30-39	$135k	$94k	7%
40-49	$151k	$294k	7.5%
50-59	$163K	$503k	8%

Source: Vanguard; Charles Schwab; Social Security

These categories are in line with those utilized by Blackrock, Wells Fargo and Fidelity.

Assumptions were made about income, salary, account balance, contribution percentage and Social Security to allow for comparisons.

Social Security assumptions

- Social Security benefits are estimated for age 67.
- Social Security contributions are made up until age 65.
- Contributions are based on salaries each year and increases of 3% each year.
- Bend point values (i.e., points utilized to determine Social Security benefit amounts) after 2023 were determined using a cost of living adjustment rate of 2.4%.

Our simulations revealed benefits in terms of both stabilized income and reduced risk. Specifically, our research found that:

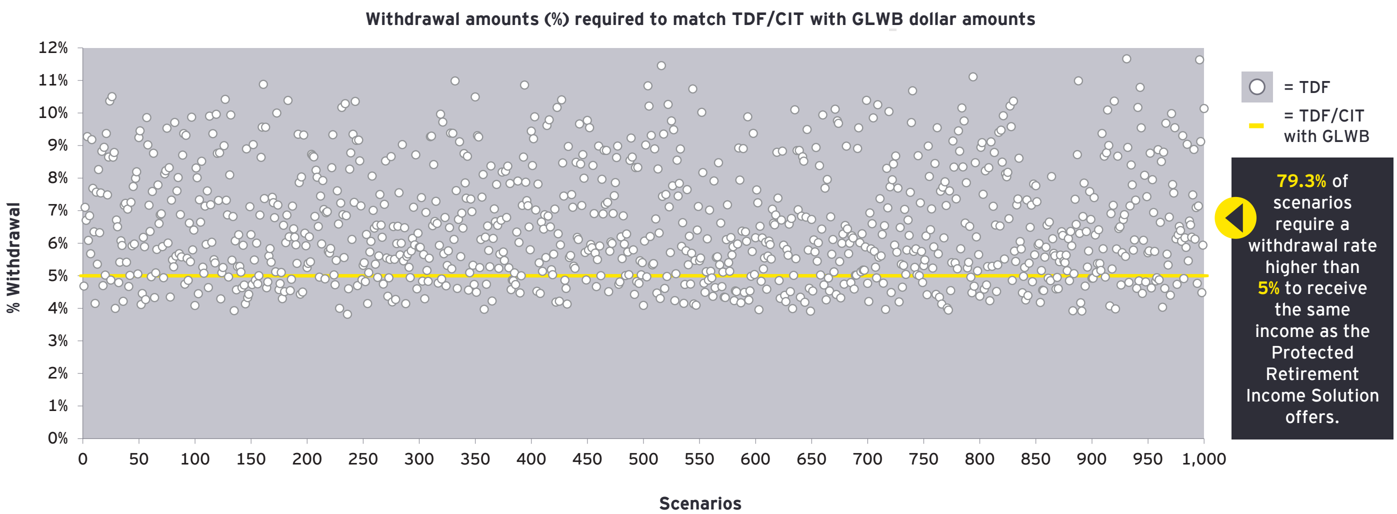
- When tested over 1,000 scenarios, meeting annual essential income needs requires lower balances at age 65 in TDFs/CITs with a guaranteed lifetime withdrawal benefit (GLWB) than in TDFs.
- Josh is currently 25 years old and is saving for retirement. He currently earns $82k per year and has $24k saved, with a 6% contribution rate per year. If Josh wants to retire at age 65 and cover essential income needs until age 85 across all the tested scenarios, he needs to invest $2.5m in a TDF/CIT with GLWB compared to $3m needed in a TDF, given that the TDF is subject to market volatility.

- The combination of TDFs/CITs with GLWBs offers greater downside protection than a TDF alone.
- When utilizing the advisor "rule of thumb" of withdrawing 4% from a TDF, retirees are exposed to market volatility. Retirees have greater likelihood of meeting essential income needs with a TDF/CIT with a GLWB compared to a TDF.

To meet annual essential income needs, individuals will need to withdraw more than 5% of their account balance in 79.3% of scenarios tested when investing in a TDF.

Figure 3: Withdrawing the same dollar value: The yellow line depicts the benefit received in a TDF/CIT with a GLWB. Due to market volatility, the percentage of an individual's account balance that must be withdrawn to match the benefit received in a GLWB product varies across scenarios. On average, the percentage of their account balance that must be withdrawn exceeds 5%.

TDF/CIT with GLWB also provide more certainty in income throughout retirement resulting from the lack of reliance on the market



TDFs may create uncertainty as the same withdrawal amount may be a higher percentage of assets due to market fluctuation

Source: EY analysis

Quantifying the value for plan sponsors: lower costs, increased asset retention, higher participant satisfaction

Our research also framed the potential benefits for plan sponsors. The findings indicate that the financial benefits for employers and enhanced outcomes for participants form the heart of the value proposition for PRI solutions. These benefits include the following:

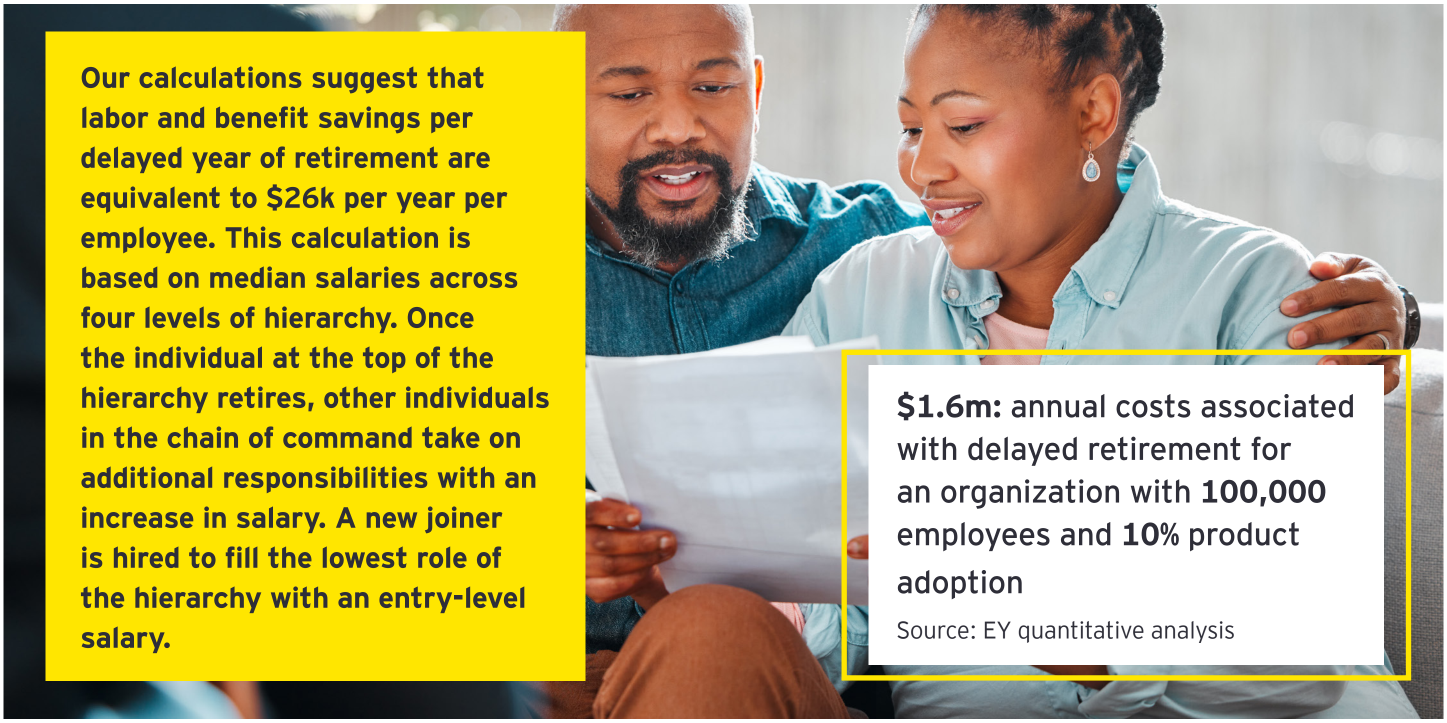
1. Compensation and benefit expenditures are reduced as employees retire on time.
2. Lower administrative fees resulting from an increase in asset retention in plan.

Reduced employer costs

While many employers seek to support their employees' long-term financial well-being, their costs rise as plan participants delay their retirement to accumulate more funds. The prevalence of these delays makes them an increasingly urgent concern. According to the Nationwide Research Institute, in 2023:

42%	of plan sponsors report an increase in delayed retirements.
61%	of company plan sponsors say that delayed or canceled retirements are a concern.
33%	of plan sponsors say market volatility has forced many employees to delay or cancel their retirement.
25%	of employees expect to retire later than they planned to a year ago.

The financial impacts – primarily in the form of higher salaries and benefit costs – are significant. Nearly half of employers, 47%, say they are paying higher salaries for longer tenured employees and 38% said health and benefit plans are becoming more expensive due to delays.



Our calculations suggest that labor and benefit savings per delayed year of retirement are equivalent to $26k per year per employee. This calculation is based on median salaries across four levels of hierarchy. Once the individual at the top of the hierarchy retires, other individuals in the chain of command take on additional responsibilities with an increase in salary. A new joiner is hired to fill the lowest role of the hierarchy with an entry-level salary.

$1.6m: annual costs associated with delayed retirement for an organization with **100,000** employees and **10%** product adoption

Source: EY quantitative analysis

For the largest employers (e.g., those with 100,000 employees) that widely adopt PRI solutions, labor and benefits cost reductions could total up to $9.75 million, if product adoption is 60%.

Increasing asset retention

There is also clear upside for employers to retain assets within their retirement plans and minimize asset outflow. That's true because plan administration fees decrease on a unit basis as plans scale up. Protected retirement solutions have the potential to reduce outflows and increase asset retention. Asset outflows from DC plans are increasingly leading to smaller balances for participants and inefficiencies for plan sponsors.

Our research showed that asset retention by adding PRI solutions may lead to annual cost avoidance of mid to high five figures per plan. While that may not seem like an enormous financial benefit, it may be meaningful to some employees. Further, PRI solutions enable employers to offer a potentially high-value post-retirement benefit that many employees are likely to appreciate.

What PRI solutions offer participants

For participants, superior results and outcomes point toward increased financial well-being. Disincentives for withdrawing lump sums strengthen many tax strategies and improve returns after retirement. Relative to participant confidence, these products can alleviate concerns related to outliving their retirement savings or not having enough income to support their pre-retirement lifestyle.

In other words, participants can feel more confident about their retirement readiness. Further, participants can easily access this benefit via their employer without the need to engage with a financial advisor or pay higher fees, as is typical with similar solutions offered outside of employer-sponsored plans.

Increased participant satisfaction can help promote employee loyalty, a significant consideration in a tight labor market. To realize that benefit, employers may need to ensure that participants understand the value of PRI products and how to use them. That education process can take advantage of participants' strong desires for protected retirement income solutions, which research from Nationwide has confirmed.

> "We made sure that people understood what these plans were, especially the annuity option and not moving in and out of them. We provided a tremendous amount of education on them so employees understood how they're designed and the intricacies.
>
> *Executive director corporate benefits, health insurance and benefits provider*

What stakeholders say:

External research – including studies conducted by Allianz and Nationwide – confirms the considerable market appeal of PRI solutions. In a 2023 survey of plan participants:

Fixed income payments in retirement, protected retirement income for life and full liquidity were cited as the most important benefits:

45%	are interested in future income payments that, once activated, cannot decrease due to market performance.
40%	want contributions and market growth to provide protected retirement income for life.
34%	want a PRI solution that offers full liquidity and access to their money at any time.

54%	expressed interest in PRI investment options included as part of a TDF.
77%	say having a PRI solution would increase their loyalty to their employer.
70%	feel that PRI solutions would increase financial security.
65%	say they would reduce stress and worry about meeting basic needs.

Given such clear and compelling benefits, there is every reason to believe that the market penetration of PRI solutions can grow significantly in the near future. Realizing this increased uptake will require the development of clear "rules of thumb" and leading practices for participant communication and education so that employees use these products in the most appropriate and beneficial ways.

The bottom line: a retirement income solution whose time has come

Plan sponsors and consultants should thoroughly evaluate the new generation of products, especially in light of how much they have evolved. Our research provides detailed quantitative evidence of potential benefits, including potentially better outcomes than TDFs can offer in many circumstances, lower administrative costs, more flexibility and increased portability and liquidity, compared to previous generations of PRI solutions.

While the financial track record of the most recent generation of products is limited, the fundamental differences in solution design make them an entirely new breed when compared to previous versions. Our research findings demonstrate that many of the old misconceptions about value and complexity no longer apply to the current crop of PRI products. Provided the industry can work through issues related to transparency, comparability and potential impacts on other parts of the business, we believe the time has come for more plan sponsors to offer PRI solutions.

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