What gets measured gets managed:

Lifetime income disclosure as a catalyst for evolution

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Table of contents

Introduction 3
The catalyst: lifetime income disclosures 4
Account balances as a lifetime income stream: a new disclosure 5
Addressing the emerging needs of participants 7
Conclusion 9

Introduction

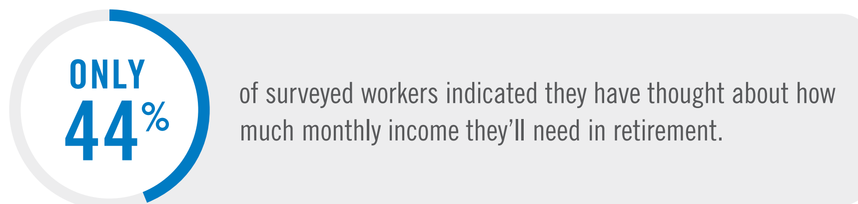
When it comes to achieving a secure income in retirement, Americans are facing headwinds sourced from multiple challenges. The evolution of defined contribution plans can help.

There is little doubt that the challenge of achieving a secure retirement has become increasingly difficult for pre-retirees and recent retirees. A significant drop in interest rates and continued volatility in the stock market are likely to create headwinds for years to come. Significant gains in longevity made by retirees in recent decades exacerbate the difficulty of ensuring retirement income will be generated for as long it will be needed. Fortunately, it is now likely defined contribution plans will start evolving and do a better job of helping pre-retiree and retirees protect their assets and generate income.

While passage of the SECURE Act in late 2019 included a few items that encourage plan sponsors to evolve their defined contribution (DC) plans to better assist participants in generating secure income in retirement, the most impactful development may be the requirement that each participant receive a lifetime income disclosure at least annually.

The catalyst: lifetime income disclosures

Unlike defined benefit plans, DC plans show the current economic value of a participant's account balance on statements and online. However, retiring workers will need to use that balance, along with Social Security and other savings, to generate income for an unknown period of retirement. In a 2020 survey, the Employee Benefit Research Institute (EBRI) found that less than half of respondents (or their spouses) have tried to figure out how much savings they'll need by the time they retire so they could live comfortably in retirement.[1] Meanwhile, only 44% of surveyed workers indicated they have thought about how much monthly income they'll need in retirement.[2]



Since many DC plan participants likely have little idea how much lifetime income his or her balance can generate in retirement, the participant might feel wealthier and more secure about retirement than he or she might be. For example, a 40 year-old pre-retiree might feel pretty good about her $125,000 401(k) balance. However, when that participant receives a lifetime income disclosure in 2021 indicating a projected income of say, $645 per month,[3] that participant is likely to experience a wake-up call and, as a result, look to improve her situation. How will she get where she wants to be at her retirement? How can she achieve investment growth? How much should she increase or decrease her contributions?

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1 Employee Benefit Research Institute, "2020 Retirement Confidence Survey Summary Report", p. 27, April 23, 2020.
2 Ibid, p. 20.
3 Example used in U.S. Department of Labor, Employee Benefits Security Administration's "Fact Sheet: Pension Benefit Statement, Lifetime Income Illustrations." P.3 which assumes 1.83% 10-year CMT rate.

Account balances as a lifetime income stream: a new disclosure

The SECURE Act amends section 105 of the Employee Retirement Income Security Act (ERISA) by requiring DC plans to include two lifetime income illustrations on participants' DC benefit statements at least once every 12 months.[4] On August 18, 2020, the Employee Benefits Security Administration of the Department of Labor issued their interim final rule (IFR) as to how administrators of DC plans should illustrate participants' projected lifetime incomes. The IFR allows the public an opportunity to comment on these methodologies before the final rule is published. The lifetime income disclosure requirements are scheduled to go into effect September 18, 2021.[5]

THE IFR INDICATES THAT DC PLAN SPONSOR PROJECTIONS MUST USE THE FOLLOWING ASSUMPTIONS:

- Participant is 100% vested
- Participant is retiring and is currently age 67, unless he/she is older; then the actual age is to be used. (Age 67 is the Full Retirement Age under Social Security for those born after 1959)
- No further contributions or investment returns
- One projection under a single life annuity and another providing a 100% survivor benefit to the spouse (also assumed to be age 67)
- Annuity projections to use the 10-year Constant Maturity Treasury rate (10-year CMT) as of the first business day of the last month of the DC statement period
- Annuity projections to use the gender-neutral mortality tables under Section 417 (e)(3)(B) of the Internal Revenue Code

4 U.S. Department of Labor, Employee Benefits Security Administration, "Fact Sheet: Pension Benefit Statements – Lifetime Income Illustrations", August 18, 2020.

5 Federal Register, Vol.85, No. 182, September 18,2020. It is important to note that, with the change in Administrations, the requirements set forth in the IFR may change and the compliance date may be deferred.

"It's likely that once defined contribution participants think of their account value in terms of projected lifetime income, they will desire additional tools, advice, and investment solutions to help them achieve their personal retirement income objectives."

Josh Cohen,
Managing Director, Head of Institutional Defined Contribution,
PGIM Institutional Relationship Group

Addressing the emerging needs of participants

There is little question that the new lifetime income disclosures will prompt many participants to take action. They will want to know how they can take steps to ensure their future savings can generate the income they will desire (rather than what may be a lower amount they see on their projections).

This is where managed accounts can assist. While the Pension Protection Act of 2006 propelled the adoption of automatic enrollment, automatic escalation of contributions, and defaults into Qualified Default Investment Alternatives, these features generally treat all participants of the same age in the same way. However, when participants get older, the assistance provided by plans must be tailored to the individual participant's situation. Managed accounts can provide such customization to help participants see what they need to do to get on track to retire.

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Managed accounts can help participants determine the age they can target for retirement, how much they should be contributing to their plans to reach their goals, and how their investments should be allocated.

Further, managed accounts can help participants model how to turn their DC savings into future retirement income. This will be especially critical for those approaching traditional retirement ages such as 67, as the lifetime income projections the participant will be used to seeing will have assumed full annuitization of the DC account. In other words, these projected income amounts will have reflected the favorable risk-pooling (and generally higher income) provided by lifetime annuities. Managed accounts will play a critical role in helping retiring participants generate monthly incomes that approach what they likely have been expecting to receive.

Eventually, managed accounts will further evolve to help retiring workers address their unique circumstances with even more precision. For instance, they will help participants generate secure income to cover their basic, non-discretionary “needs.” As many DC participants have historically shown a reluctance to fully annuitize their retirement savings, these managed account offerings to cover needs must include non-guaranteed sources of dependable income in addition to guaranteed sources.

To generate income to cover things retirees might want beyond their needs — vacations, travel, entertainment, bequests — retirees will likely gravitate toward investing in diversified risk assets, such as stocks.

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Managed accounts have the added benefit of helping to mitigate suboptimal investor behavior. This is of critical importance as participants enter their pre-retirement years, as much more is at stake and a misstep can be the difference between a secure retirement and running out of money. Recent research published in June 2020 found that participants in managed accounts were less likely than others to sell out of equities during the brief, significant bear market that occurred in February through March of 2020.[6] During this period, the S&P 500® dropped 34%.[7] The researchers determined that those in managed accounts may have had higher levels of trust in their portfolios due to the increased customization managed accounts offer.[8]

6 Blanchett, David and Michael Finke, “Portfolio Delegation and 401(k) Plan Participation Responses to COVID-19”, p. 19, June 2020.
7 Ibid, p. 1.
8 Ibid, p.19.

Conclusion

In the private sector, DC plans are now the dominant source of retirement income beyond Social Security. Fortunately, when lifetime income disclosures are introduced in 2021, as a result of changes to ERISA, plan participants will be forced to consider their DC wealth in terms of retirement income. For many participants, this will be a wake-up call and they will look for tools to help them address and prepare for their individual retirement objectives. In effect, it's very likely that lifetime income disclosures will be the catalyst that helps DC plans evolve from savings plans to retirement income plans.

“The furnishing of lifetime income illustrations is a critical step toward assisting working Americans frame defined contribution plan balances as a source for retirement income, rather than merely an asset accumulation vehicle.”

Yanela Frias
President, Prudential Retirement
In November 3, 2020 comment letter

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