Lifetime income illustrations: Preparing for participant reactions

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With passage of the SECURE Act in late 2019, Congress sent a message that defined contribution (DC) retirement savings plans must do a better job of helping workers generate income throughout their retirement years. A key component of that message was a requirement that plans provide participants with a projection each year illustrating how much lifetime income their account could generate once they stop working.

These income illustrations will go a long way toward reframing the discussion around DC plans from a singular savings goal to future retirement income. It also will send participants looking for help with meeting their income goals.

In our last paper on the evolution of DC plans, "What Gets Measured, Gets Managed," we looked at why lifetime income disclosures will be a catalyst for evolving DC plans into true retirement income plans. In this report, we take a deeper dive into lifetime income illustrations. We look at how they must be calculated, and share a few examples of how they might make retirement plan participants more aware of their income challenges and opportunities. Finally, we share new survey data showing how participants might react to their lifetime income projections.

Calculating lifetime income disclosures

In accordance with the SECURE Act, the Department of Labor issued an Interim Final Rule in September 2020 spelling out how lifetime income disclosures must be calculated. The rule specifies that a plan participant's current account balance must be used to illustrate their potential retirement income, regardless of how old they are or how long they have been saving. It requires that their projected income be illustrated under two different scenarios, each of which assumes the participant converts their account balance to a lifetime income annuity and that the participant has reached age 67 (unless the participant is over the age of 67, in which case the actual age is used). The first scenario assumes conversion to a single life annuity. The second assumes conversion to a qualified 100% joint and survivor life annuity covering the participant and a spouse (with the spouse also at least 67), regardless of whether the participant is, in fact, married.

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It is important to note that any future contributions to the retirement account, and any future investment earnings within the account, are excluded from these projections. This means the illustrations will only show what the participant's current account balance might yield, not how much the participant could expect to receive if they continued to work and save. The rule further requires that the interest rate used in calculating retirement income be the 10-year constant maturity rate (10-year CMT) as of the first business day of the last month of the statement period. These assumptions will be standard across the industry.

The mortality table that is required to be used is the gender-neutral mortality table under section 417(2)(3)(B) of the Internal Revenue Code. This table, along with the current interest rate will drive the estimated payout. Gender-neutral tables generally favor females since their lifetime income amounts are not reduced for their longer life expectancies than males. For example, if a retiring female worker rolled her 401(k) balance to an IRA and subsequently looked to purchase an immediate annuity with a lifetime payout, she would find that her monthly income would be less than that of a male of the same age as she is expected to live longer.

Observations

Under the DOL rule, lifetime income illustrations will effectively provide a snapshot of where participants are at that moment, as if they were retiring at that time. Because the projections will not account for future contributions or investment earnings, the illustrations will greatly underrepresent future retirement income for most plan participants other than those very near retirement. Many of these participants will need more information to help them assess whether they are on track to meet their retirement income goals. They will want to know what steps they can take to get on track if they have fallen behind, and how to allocate their plan assets given their personal funding level.

Participants who are nearing retirement, meanwhile, may become conditioned to the idea of living on the illustrated monthly benefit, only to be disappointed later. Why? The illustration is a single number that assumes they annuitize their entire DC account balance when they retire. This approach will generally produce a number higher than what participants will be able to prudently withdraw from their accounts without annuitizing, assuming they don't want to dramatically increase the risk of outliving their savings. In addition to adjusting to a lower level of retirement income, these participants will have to recognize that they are effectively self-insuring against longevity risk.

With momentous financial decisions to be made, participants will be looking for help with figuring out how to achieve their illustrated monthly income amount.

They'll also need help understanding the tradeoffs they'll be making depending on which approach to lifetime income they choose: drawing down money on their own and hoping it will last, or annuitizing.

The 10-year CMT rate will play an important role in income projections and the degree to which they fluctuate over time. The higher the rate, the larger projections will be, everything else being constant. As of March 1, 2021, the CMT rate was 1.45%.[1] But its record high was 15.84% set in September 1981.

1 U.S. Department of Treasury, March 2021, https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/textview.aspx?data=yield

Exhibit 1—10-year constant maturity rate

Source: Federal Reserve Bank of St. Louis

Using the March 2021 rate, a $300,000 account balance would be projected to generate monthly retirement income of $1,493 ($17,916 annually).[2] At the September 1981 rate, by contrast, the projections would be more than two and half times higher at $4,146 per month ($49,752 annually).

Of course, high interest rates are often accompanied by high levels of inflation, which can eat away at the purchasing power of a higher income. The high levels of inflation we saw in the 1970s and 1980s were particularly devastating for retirees living on fixed incomes from pensions or Social Security.

A wake-up call for plan participants

Olivia Mitchell, executive director of the Pension Research Council, believes the new lifetime income projections will be a wake-up call for many retirement plan participants.

"The new lifetime income disclosure information will come as a shock to many, since few people know how much money it takes to live throughout retirement," Mitchell says. "In fact, my recent study shows that longevity risk is an alien concept to many and having the income disclosures will help make this much more real."[3]

2 All calculations in this article have been modeled by Prudential.
3 Mitchell, Olivia to Prudential, February 10, 2021.

How much will income projections change year to year?

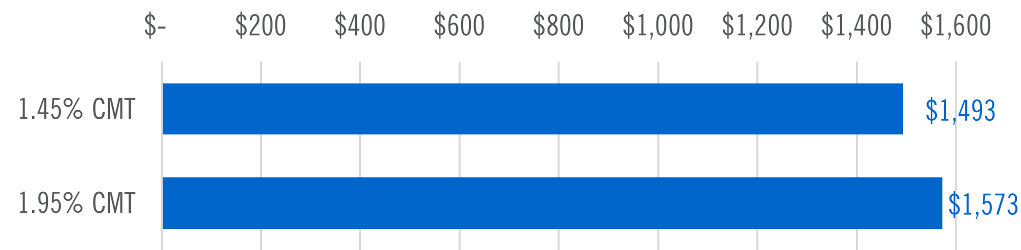
Changes in year-to-year income illustrations will vary in size depending not just upon the course of interest rates but also on changes in how much participants contribute to their plan and fluctuations in investment returns. In general, the smaller a person's account balance, the greater percentage change they could see. A new plan participant with a year-one account balance of $1,000, for example, might see that it equates to $5 a month in retirement income. But this participant could see a nearly five-fold increase in their projection—to $25 a month—if their account balance increases to $5,000 in year two (assuming the CMT rate remains unchanged).[4]

Since most plan participants will make ongoing contributions to their accounts, they are likely to see their income projections grow over time. Even when financial markets stumble, ongoing contributions may offset negative investment returns to some degree.

Year-over-year changes could be particularly pronounced when interest rates are volatile. Over the last 30 years, the largest year-over-year change in the CMT rate occurred in 1996 when it dropped to 5.60% from 7.88% a year earlier.[5] When the rate falls, it has a negative impact on projected monthly income, and when it rises the effect is reversed. For a participant with a $300,000 account balance, for example, an increase in the CMT of just half a percentage point, to 1.95% from 1.45%, would increase their projected monthly income by $80 to $1,573, up from $1,493.

4 Based on a CMT of 1.45%, the rate as of March 1, 2021.
5 Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org.

Exhibit 2—50 bps increase in CMT



For illustrative purposes only.

Let's look at a few examples of how monthly lifetime income projections might impact plan participant behavior. Prudential surveyed 401(k) participants in April 2021 to gauge their responses to three income illustration scenarios,[6] each using the March 1, 2021, CMT rate of 1.45%.

Example one:
Early-career savers seeing low illustrations in first year of disclosure

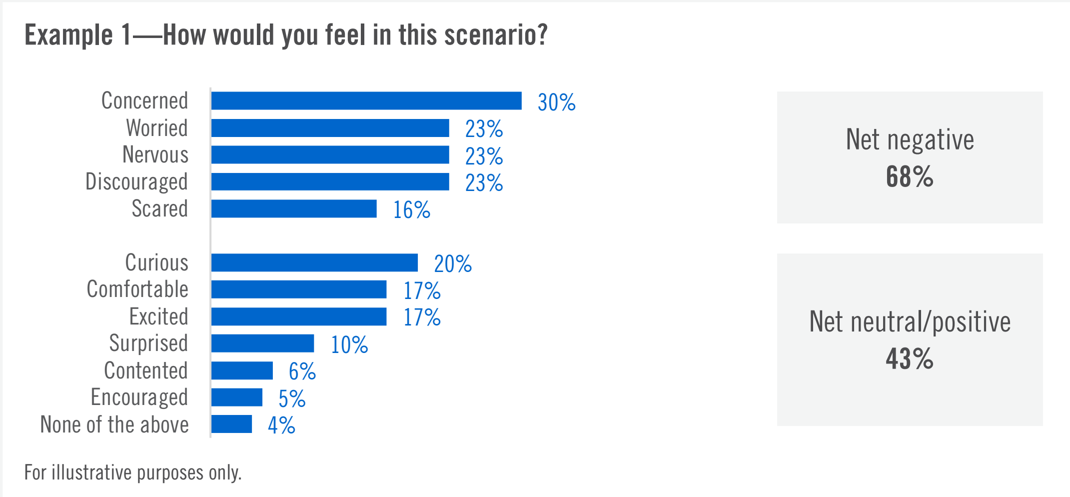
Lifetime income illustrations will appear small to those with small account balances, which may cause them to become discouraged—or seek help with improving their situation.

The survey asked participants to *"imagine a scenario where your 401(k) balance is $20,000 and you receive a notice that this amount can generate an income for you of $100 per month for life in retirement."*

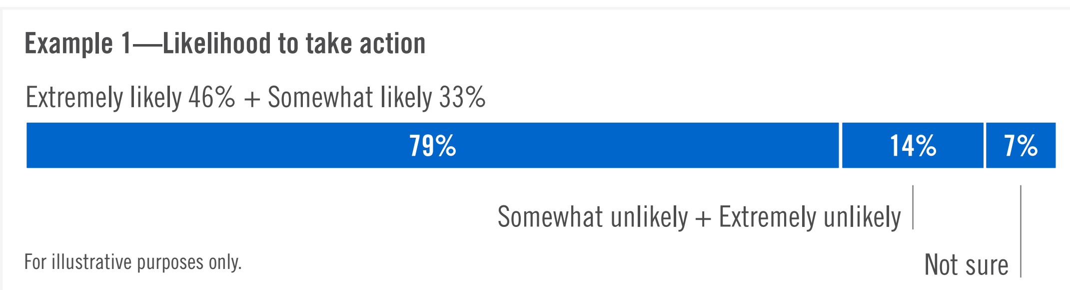
Survey respondents were asked to indicate all their likely reactions. Overall, 68% of their responses could be considered net negative—more negative than positive. Within this category, 30% of participants indicated they would be concerned, 23% worried, and 16% scared. Their responses that could be considered net neutral or positive included 20% indicating they would be curious, 17% comfortable, 17% excited, 10% surprised, and 5% encouraged.

Overall, 68% of their responses could be considered net negative—more negative than positive.

6 Poll conducted by Morning Consult on behalf of Prudential Financial April 27-28, 2021.



As a follow up, the survey respondents were then asked, *"How likely or unlikely would you be to do something or take action with respect to your retirement plan in this scenario?"* Forty-six percent indicated they would be extremely likely to take action, with an additional 33% saying they would be somewhat likely. Specific actions respondents said they would take included increasing their contributions, investing more aggressively, and reaching out to their plan provider to learn more.



Example two:
Early career savers seeing modest but steady year-over-year progress

In addition to understanding how they react to small income illustrations, it will be helpful for plan sponsors to understand how participants might respond to incremental but modest improvements in their projected lifetime income over time. Survey participants ages 25 to 40 were presented with the following situation:

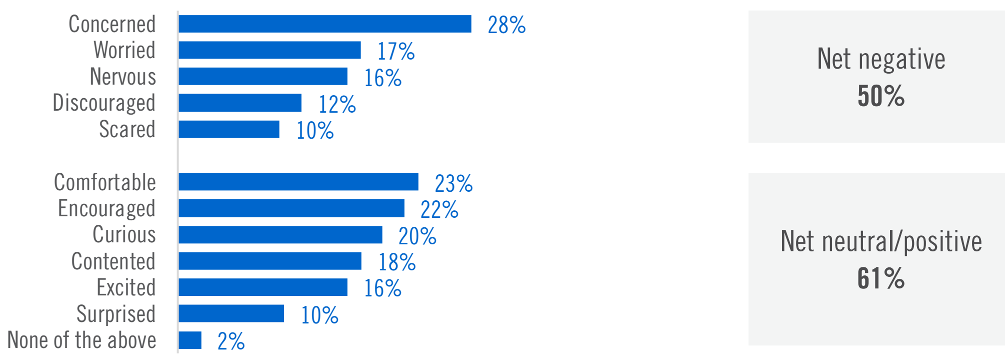
"Imagine a scenario where your retirement account balance in your employer retirement plan (for example, a 401(k)) is increasing by $5,000 from year to year, from $10,000 to $15,000 to $20,000 and so on, and this increase in your balance is generating for you an increase of $25 in your monthly retirement income from $50 to $75 to $100 as illustrated below. How would you feel in this scenario?"

	Your retirement account balance	Your projected lifetime monthly income at retirement
Year 1	$10,000	$50
Year 2	$15,000	$75
Year 3	$20,000	$100

Responses were mixed but more positive than in the earlier scenario, with 28% saying they would be concerned, 23% comfortable, and 22% encouraged.

Responses were mixed but more positive than in the earlier scenario. Overall, 50% were negative, versus 68% in the first example.

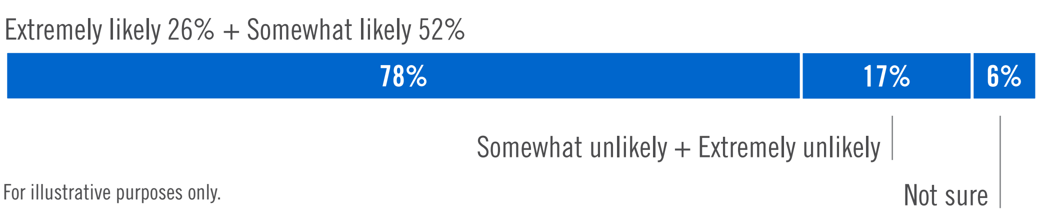
Example 2—How would you react?



For illustrative purposes only.

As with the first example, respondents were then asked a follow-up question: *"How likely or unlikely would you be to do something or take action with respect to your retirement plan in this scenario?"* More than three out of four indicated they would be extremely likely (26%) or likely (52%) to take an action, such as increasing their contribution or reaching out to their plan provider.

Example 2—Likelihood to take action



For illustrative purposes only.

Example three:
Near retirees seeing projected income higher than actual income

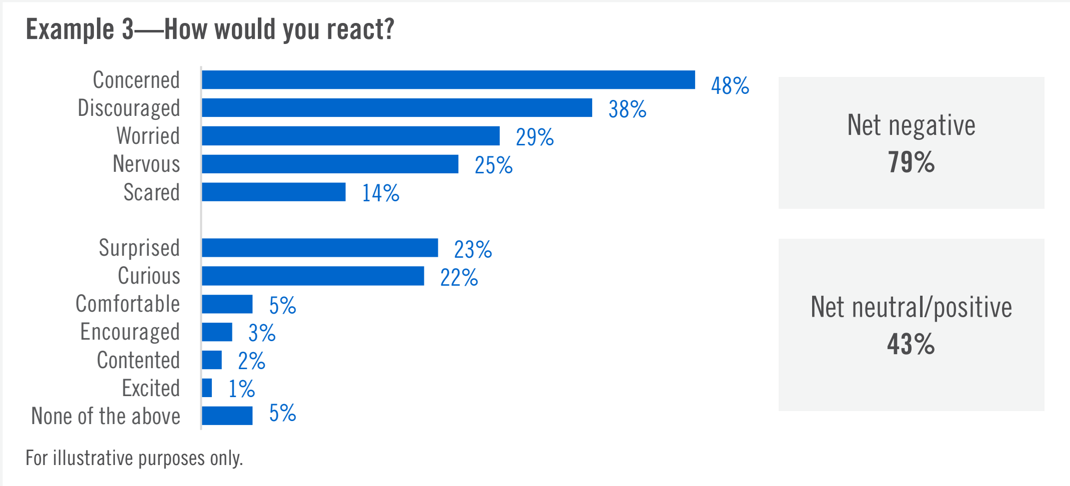
Over time, we anticipate that DC plan participants will become accustomed to seeing their account balance framed as monthly income. We also expect that some if not most of them will come to see the illustrated amount as the amount they will actually get in retirement. But as we've already noted, this figure assumes the participant's full account balance has been annuitized. In the real world, very few retirees annuitize all their retirement assets. A much more popular approach to generating income is to draw down retirement assets using a systematic "safe withdrawal rate"—a rate at which, under most financial market scenarios, the investor will not outlive their assets. The most commonly cited safe withdrawal rate is 4%, in which the investor withdraws 4% of their account balance in the first year of retirement, and then adjusts that withdrawal amount annually for inflation in succeeding years.[7]

An initial withdrawal rate of 4% will typically generate less income than participants would receive by annuitizing their account balance. To find out how pre-retirees would feel about this discrepancy, the survey asked those with 401(k) balances under $250,000 to consider the following scenario (pre-retirees with higher balances were presented with a different set-up):

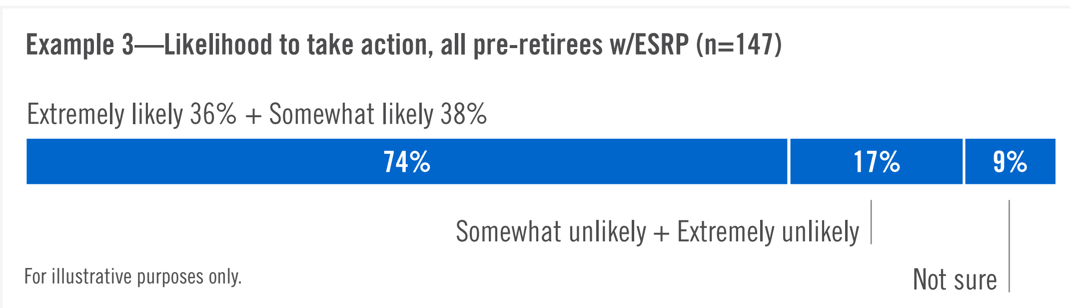
"Imagine a scenario where you are retiring in one year and you have $200,000 in your current employer's retirement savings plan (for example, a 401k). You have received statements indicating that this amount can generate $966 in monthly retirement income for yourself, payable for life. Right before your retirement, you learn that the $966 indicated in your statements will only be $666. The reason it is less is that financial experts suggest withdrawing only 4% of your initial retirement balance annually if you wish to retain access to your assets and have a good chance of not running out of money in retirement. The amount communicated in your statements was based on annuitizing your full account balance."

When asked how they would feel in this scenario, nearly half the pre-retirees (48%) indicated they would be concerned, 38% said they would be discouraged, and 29% indicated they would be worried. (Net negative 79%)

7 While many researchers and practitioners question whether 4% is the optimal safe withdrawal rate at this point, it continues to be the most commonly discussed rate and is used in this simple example.



When they were then asked whether they would take action in the scenario described above, approximately three out of four said they would be extremely or somewhat likely to do so.

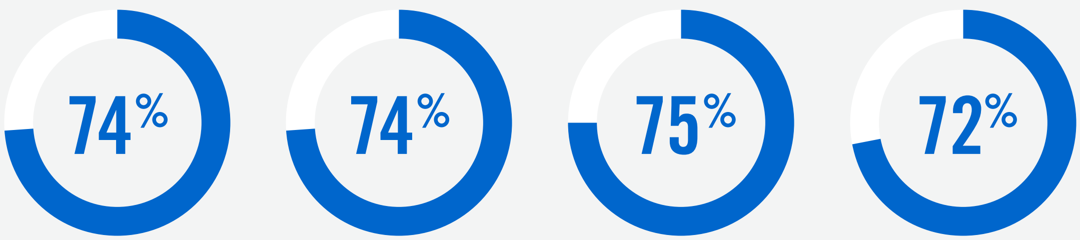


When asked specifically what action they would take, more than 60% of respondents said they would seek help from their plan provider, such as reaching out to learn more and engaging with retirement planning tools and calculators.

Interest in following advice, information, tools, and solutions

As a result of the new lifetime income disclosure requirements, many participants will seek guidance from their DC plans to help them get on track to achieve their individual income goals. Based on the scenarios outlined in this paper, when asked how interested they would be in each of the following types of information, advice, or service, survey participants provided the following responses.

Early savers



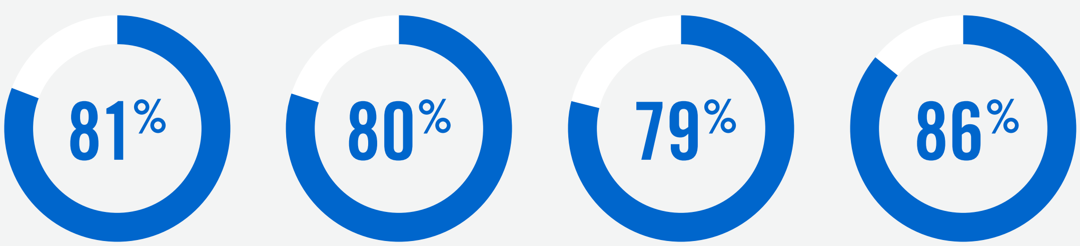
Advice on **how best to stay on track** for retirement savings

Information on **whether I am on track** with retirement savings

Solutions and **tools to enhance my retirement savings**

Solutions and **tools to enhance my retirement income**

Pre-retirees



Advice on **how best to stay on track** for retirement savings

Information on **whether I am on track** with retirement savings

Solutions and **tools to enhance my retirement savings**

Solutions and **tools to enhance my retirement income**

Conclusion

Lifetime income disclosures will be a great initial step to get plan participants to think in terms of retirement income and not just in terms of building retirement savings. With this increased awareness, many participants will look to their DC plans for additional tools to help them get on track to their individual income goals. Driving behavioral change is critical to helping those who are behind, get on track.

The survey results strongly indicate that many participants will be motivated to take additional action to improve their projected lifetime income. This is a good result. This also means it will be critical for participants to receive further advice and guidance from plan sponsors so they can glean greater meaning as to what this retirement income projection means in terms of whether they are on track.

Lifetime income disclosures will likely change how workers think about their DC plans. However, like target-date funds, the disclosures treat everyone in a similar way. We know that participants have different income needs, expenses, timing, and appetite for risk. To address these needs, plan sponsors will need to evolve their DC plans across several areas:

- **Communications:** Personalized and customized messaging will need to become more front and center and include a focus on retirement income, especially as workers approach their pre-retirement years.
- **Education/Advice:** Managed accounts, planning tools, and calculators will each become more important as participants seek out guidance and need customized solutions tailored to their situation.
- **Investment Solutions:** Participants will need investment solutions to help them increase the probability of meeting the income projections they are shown and manage the unique risks that generating lifetime income poses. Institutional investments will continue to play a critical role in growing assets in a risk-controlled manner, but additional non-guaranteed income solutions will be needed to manage the payout and interest rate risk individuals face. In addition, guaranteed income will be important to help manage longevity risk that these projections are assuming is already built in.
- **Financial Wellness:** Financial wellness programs will increase in importance to help participants improve their budgeting in order to save more as well as address student loan and other types of debt.

At least now, thanks to the disclosure rule, attention will turn to lifetime income, a transition that is long overdue. Accordingly, the income disclosures are likely to be a large catalyst to evolve DC plans from savings plans to true retirement income plans.

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