NORTHERN TRUST

PLAN SPONSOR UPDATE

SECURE lifetime income provisions, 2019 interest rate declines, and the DC participants' retirement income challenge

Two headline provisions of the Setting Every Community Up for Retirement Enhancement (SECURE) Act, included in the year-end budget package signed into law on December 20, 2019, were a new defined contribution plan annuity fiduciary safe harbor and a requirement that DC plan administrators provide participants an annual "lifetime income" description. Another major 2019 development – the 75-100 basis points decline in medium- and long-term interest rates – make the issue of retirement *income*, as opposed to asset accumulation, critical for DC plan participants.

In what follows, we first review two retirement income-targeted provisions of SECURE – the fiduciary safe harbor and mandatory lifetime income disclosure. We then consider how the decline in interest rates in 2019 has affected DC plan participants. We conclude with a consideration of actions that sponsors can take to help participants address the retirement income challenge.

Retirement income provisions of SECURE – DC annuity safe harbor

As a general matter, many DC plan sponsors have been reluctant to add an annuity option because of possible fiduciary liability – perhaps years after the selection of the annuity carrier – based on a claim that the fiduciary should have known that the carrier was not "financially capable of satisfying its obligations."

In 2008 DOL finalized a regulation providing a safe harbor for the purchase of annuities in a DC plan. While that rule improved on DOL's "safest available annuity" standard, it still imposed significant duties on plan fiduciaries, including that the fiduciary appropriately conclude that "at the time of the selection, the annuity provider is *financially able* to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract."

January 2020

SUMMARY
In this article we consider the effect of 2019 interest rate declines on DC plan participants, the significance of certain retirement income provisions of SECURE in this regard, and approaches sponsors may want to consider to help participants meet the challenge declining interest rates present.

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In the view of many sponsors, this regulation did not solve the problem of fiduciary risk, and most 401(k) plans still do not offer in-plan annuities.

SECURE addresses this issue by, generally, deferring to state insurance regulation on the issue of the financial condition of the annuity carrier. Under SECURE, a fiduciary would be deemed to satisfy the "financially capable" requirement if it obtains certain representations from the insurer (e.g., that it is appropriately licensed and has complied with certain state regulatory requirements). The insurer must notify the fiduciary of any relevant change in circumstance, and the fiduciary cannot be aware of other facts that would cause it to question the insurer representations.

(Effective as of date of enactment.)

Mandatory lifetime income disclosure

SECURE requires DC plan administrators to annually provide participants a description of the monthly "income stream" they would receive if their account balance were paid in the form of a single life annuity and joint and surviving spouse annuity, based on assumptions specified in DOL guidance. DOL is instructed to issue model disclosures.

SECURE provides that plan fiduciaries shall not be liable "solely by reason of the provision of lifetime income stream equivalents" derived from DOL prescribed assumptions and rules.

(Effective 12 months after regulations are issued.)

Asset returns, interest rates, and retirement income

The S&P 500 is up around 30% for 2019 – the second-best year in two decades. Many 401(k) plan participants are feeling very good about 2019. But if a participant's objective is to produce retirement *income*, then 2019 was not as good a year as a focus exclusively on asset accumulation might indicate – because the cost of producing income went up significantly during the year.

As economist (and former director of the National Economic Council for President Obama) Lawrence Summers recently explained: "Wealth can go up because future income streams go up ... or wealth can go up because the discount factor goes down. ... The Shiller Price Earnings Ratio is 76% more than its post-war average. That would explain all of the increase in wealth relative to income." (Remarks of Lawrence Summers, *Would a "Wealth Tax" Help Combat Inequality?* A Debate with Saez, Summers, and Mankiw, Peterson Institute for International Economics, October 18, 2019.)

Consider a 35 year old participant, planning to retire in 30 years. At the beginning 2019, the cost of $1,000 payable in 2049 (when she turns age 65) was $265. At the end of 2019, the cost of the same $1,000 was – because of the 2019 decline in interest rates – around $370, a 40% increase, wiping out her stock market gains.

The most obvious place this increase in the cost of retirement income will show up is in an increase in the cost of annuities. But it will (implicitly) increase the cost of any income-producing strategy.

Most 401(k) plan participants do not intuitively understand this connection between interest rate declines and an increasing cost of retirement – they may think that they are "on track" because their assets increased significantly in 2019. But the decline in interest rates sends an important signal for participants counting on their 401(k) plan for retirement income. Understanding this signal, a participant may want to consider saving more, changing their asset allocation strategy, or evaluating alternatives (e.g., working longer or living on less in retirement).

Takeaways for plan sponsors – helping participants meet the retirement income challenge

Helping participants develop an understanding of their own "retirement outcome" –

Lifetime income disclosure. As noted above, SECURE includes mandatory lifetime income disclosure for DC plan participants, in accordance with rules to be prescribed by DOL. Many sponsors already provide participants with this sort of information. To the extent that a sponsor's approach to this reflects changes in interest or annuity purchase rates, the recent interest rate declines will show up as reduced retirement income – perhaps offset by increases in asset values. This sort of communication permits participants to get a more accurate picture of what – based on their current savings – their retirement income will be.

In-plan annuities. The SECURE DC plan fiduciary annuity safe harbor addresses (for the most part) one of the major sponsor concerns about offering in-plan annuities. Sponsors may want to consider this option. We also note that DOL is said to be working on a revision to the Qualified Default Investment Alternative (QDIA) regulations to allow the inclusion of annuities in, e.g., a default target date fund. To state what may be obvious: a participant investment in an annuity now is a hedge against future declines in interest rates/increases in annuity purchase rates.

Reevaluate the 4% drawdown rule. Many expect that, in addition to interest rates, returns generally will go down/remain low in the future. In

this context, sponsors that provide information about drawdown strategies may want to consider whether the 4% drawdown rule-of-thumb is still appropriate, or for example, whether 3% is the "new" 4%.

Strategies to address the greater cost of retirement income –

Consider encouraging greater savings. In an era of lower interest rates, sponsors may want to consider communicating the need to save more to meet retirement income targets, where a participant has saving/spending flexibility.

Consider whether communication/counseling about "Plan B" may be useful. Many participants may not be able to meet the increase in the cost of retirement income by simply diverting more of their pay to retirement savings. The standard Plan B is living on less or working longer.

Consider alternatives that will improve participants' "annuity deal." The retail annuity market can, for a participant, be expensive and difficult to navigate. Sponsors may be able to provide alternatives, either directly – through in-plan annuities – or indirectly, by developing ways for participants to access the institutional market or raising awareness about the value of deferring Social Security benefits.

Declining interest rates present a fundamental challenge to participants saving for retirement, signaling an increase in the cost of future income. One critical tool in addressing this challenge is increasing participant awareness. Another is to provide alternatives (e.g., in-plan annuity options) that allow participants to lock in (currently) the cost of future retirement income. It's fair to say, however, that many believe we need more tools to meet this challenge.