The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

April 2024

PROVIDING LIFETIME INCOME IN A DC WORLD:

THE LONG AND WINDING ROAD

"Our research suggests that DC plan advisors, consultants, and plan sponsors have reservations about in-plan annuities. Generally, in-plan lifetime income options are expensive, complicated, resource-intensive, hard to explain, not flexible, not portable, and uncertainty about fiduciary duty may linger…"

From a special report on Retirement Income by *Pensions & Investments*
March 11, 2024

"BlackRock's LifePath Paycheck looks and feels like its existing index target-date fund. However, LifePath Paycheck gives participants the option to convert part of their assets into a lifetime income stream, starting at age 55. BlackRock has a robust process for choosing the insurance company that will provide the annuity, thus alleviating that burden from the plan sponsor."

From an article on new products in *PLANSPONSOR*
Feb. 29, 2024

"The award-winning Lifetime Pension helps you enjoy life without worrying about your savings running out. It was the first of its kind in Australia and is designed to work together with your Retirement Income Account. The Lifetime Pension provides market-linked income that is annually adjusted."

From the website of the *Australian Retirement Trust*

Are We There Yet?

This *Letter* provides an update on traveling the long and winding road to the provision of lifetime retirement income to private sector workers in addition to basic universal government pensions. The need for a simple cost-effective solution is well-established. For example, a recent US study found only 21% of workers believed they were accumulating sufficient retirement assets to maintain their standard of living in retirement. The fear of outliving one's retirement savings was obviously strong. Yet, at the same time, another study found that in a sample of people retired for 20 years, a majority still had most of their pre-retirement assets left.[i] Clearly, that 'outliving your assets' fear continued to be strong during the retirement years, leading to scrimping and underspending, rather than enjoying life after work.

Despite the clear need for lifetime income in retirement, the "Special Report on Retirement Income" in the *Pensions & Investments* issue cited above has the subtitle "Plans wrestle with cost, complexity, and other concerns when considering retirement income solutions". Here are a few highlights from the Report:

- A recent survey on retirement income provision reported 68% of responding employers were concerned about complexity and participants' understanding. Other concerns involved fees, adequate choice, administrative burden, and lack of participants' engagement.

- Employers do not want to get too far ahead of the curve on this topic. Some are kicking the tires, but it's just not a topic of conversation. The appetite for change is generally low. There is also disagreement on what to call in-plan lifetime income options. The word 'annuity' was deemed unpopular, but no obvious alternative has yet surfaced.

Is there an end in sight on the long and winding road to lifetime income provision?

Is *BlackRock*'s *LifePath Paycheck* the Answer in the USA?

The issue of *PLANSPONSOR* magazine quoted above carried an article titled: "***BlackRock* Prepares *LifePath Paycheck* (*LPP*) to Address In-Plan Retirement Income**". It notes that 14 plan sponsors with an aggregate DC assets of $27B are working with *BlackRock* to implement *LPP* in their DC plans. This is how *BlackRock* describes its *LPP*:

- Its *Target Date Fund* (*TDF*) structure automatically reduces equity exposure as workers age. The *LPP* logically fits into that structure by offering a lifetime income option, which also meets the DOL's requirement for a *Qualified Default Investment Alternative* (*QDIA*).
- At age 55, the *LPP* structure introduces a new offering called the *LPP Income Fund*. This fund invests a portion of its assets in deferred group annuities contracts and creates options for participants to purchase lifetime income streams. Participants can elect to exercise these options between ages 59.5 and 71. Target is to have 30% of assets in deferred group annuities by age 65. Any assets remaining in the *LPP Income Fund* by age 71 will go into the 40/60 retirement fund.
- *BlackRock* will support these processes digitally through *MyLifePath*. This platform permits the required integration between the employee, the employer, the pension plan recordkeeper, and the annuity provider.

BlackRock is to be commended for undertaking its *LifePath Paycheck* initiative. How will US employers and employees respond? Time will tell.[ii]

Meanwhile, time is already telling an interesting story 'down under'.

Australia's *ART* Goes a Different Route

With its compulsory multi-decade DC 'super' system, it was inevitable that Australia would eventually develop its own approach to providing workers with a lifetime income option in addition to the universal *Age Pension*. The most successful result to date is the *Australian Retirement Trust*'s (*ART*) *Lifetime Pension* offering. Its creation is an interesting story worth recounting.

Four years ago, actuary Brnic van Wyk was tasked with learning what the rest of the world was doing to address the lifetime pension design challenge. To his surprise, he found the simplest design in Canada, embedded in the *University of British Columbia*'s *Faculty Pension Plan*. Its lifetime income pool with the somewhat awkward name *Variable Payment Life Annuity* (*VPLA*) was launched in 1967.[iii] *VPLA*'s two key differentiators were to (a) embed a longevity risk mitigation mechanism in an investment pool, and (b) to annually reset the pool payout to maintain its ongoing long-term solvency.

After a period of design and testing, *ART*'s *Lifetime Pension* offering launched in March 2021, open to participants in the age range of 60-80. Initial lifetime payouts are based on start date, age, and joint survivor status. Minimum required contribution into the pool is AUD$10,000, maximum AUD$1.9M. There is also a 6-month 'money-back' liquidity option to address the 'fear of early permanent loss' factor tied to standard life annuities.

In the three years since the *Lifetime Pension* offering opened in 2021, it has accumulated an encouraging AUD$260M in contributions, ranging in size from AUD$10,000 to AUD$1.7M.

The average individual balance allocated to a *Lifetime Pension* was AUD$224K, with participants allocating an average of 54% of their total pension assets. Average contributor age was 68. The *Lifetime Pension* offering has been winning 'best design/innovator' awards both in Australia and internationally.

What About Canada?

Readers who assumed that the 1967 *VPLA* innovation at *UBC* would subsequently sweep across Canada will be disappointed. Due to an unhealthy combination of inertia and regulatory complexities, it was not until 2021 that *Purpose Investments* launched its *Longevity Pension Fund* (*LPF*) based on the *VPLA* formula. With the continued complexity enveloping pension regulation in Canada, *Purpose Investments* chose to launch *LPF* as a mutual fund rather than a pension fund in order to ensure all Canadians have access to lifetime income.[iv] After over two years of operation, the *LPF* is technically unfolding as projected. Along the way, it has also garnered favorable attention from the *Canadian Association of Retired Persons* (*CARP*) and the media. However, without *ART*'s direct distribution power, *LPF* uptake has been slower than anticipated thus far.

The *CommonWealth* organization chose a different path to disrupting Canada's pension industry. It bills itself as a 'digital group retirement platform', working mainly in the small to mid-size employer market. Its suite of services encompasses not just retirement income accumulation structures (e.g., *BlackRock*'s target date funds), but also digital education and planning tools for members, easy administration for employers, and tools for advisors. It can also integrate life annuities into its retirement income structures. Plan members in group RRSPs aged 50 or older have the opportunity to purchase *Brookfield Annuity Company* deferred annuities, eventually receiving automated payments directly into their bank accounts.

The not-for-profit *CAAT Pension Plans* offers yet another approach to pension innovation in Canada. An established provider of pension services to Ontario's applied arts and technology education sector, it has successfully offered its investment and benefit administration infrastructure to other employers across Canada. The result has been the creation of *DBplus* pension arrangements where external employers only commit to making pension plan contributions at their desired rate (i.e., DC fixed cost), but without underwriting any balance sheet risk. Meanwhile, retirees are paid lifetime pensions from balance sheets that also house the future payment obligations to working employees. Risks are borne through carrying balance sheet surpluses, and if necessary, adjustments to future accruals. *CAAT* will also be launching a new personal accumulation and decumulation option to its members at the end of this year. Similar to *UBC*'s approach, this option will allow members to earn *CAAT*'s net rate of return on their account balances and then choose from various decumulation options, including a *VPLA* (once regulations allow for that option). This innovation will also allow members to tailor their retirement beyond their secure pension from *DBplus*. Early member and employer response to this planned new option has been positive.[v]

Despite these three innovative initiatives, much work remains to be done in Canada. A far greater proportion of currently existing retail retirement savings needs to be cost-effectively converted to lifetime income streams. Canada's financial sector needs to step up.

The Long and Winding Road: Where To From Here?

A key message of this *Letter* is that the long and winding roads to lifetime income are country-specific:

- <u>In the USA</u>: a big question for now is how the current *BlackRock LifePath Paycheck* initiative will play out over time. Can it overcome the documented discomfort of US corporate employers with in-plan annuities? What about the design of *LPP* itself? Will *BlackRock* make adjustments to it based on actual experience? And what about the mass of individually-owned *IRA* retirement assets currently in their decumulation phase? Who will invent a simple lifetime decumulation offering for their owners?

- In AUSTRALIA: with *ART*'s successful launch of its *Lifetime Pension* initiative, how are their competitors responding? They are introducing options and features such as choice of the hurdle rate, multiple investment options, deferring the income commencement date, and including a death benefit. While all of these features may seem compelling, they all introduce additional layers of complexity and the need for registered professional financial advisors. It remains to be seen how much uptake there is for these additional features.
- In CANADA: the *CAAT Pension* organization is to be commended for demonstrating that enough flexibility can be inserted into collective DB arrangements that they continue to be a viable retirement option for corporate and not-for-profit employers. At the same time, the *CommonWealth* organization is showing that the right combination of accumulation/ decumulation design, digital employer and employee support, and the right providers of investment and lifetime income services can create attractive retirement plan offerings for mid-size and smaller employers. Finally, *Purpose Investments* has successfully launched its *Longevity Pension Fund* based on the original *UBC Variable Payment Lifetime Annuity* (*VPLA*) model. It now needs a distribution strategy to capture the large pool of individually-owned retirement assets currently in their decumulation phase.
- In REST-OF-WORLD: the UK and the Netherlands have both been rethinking the designs of their supplementary pension systems. They, as well as other countries with large supplementary pension systems, can learn a great deal from the developments described in this *Letter*.

A Final Thought

One idea in this *Letter* that is not country-specific is the *VPLA*. In contrast to the traditional insurance company-issued guaranteed life annuity, there is no need to set aside capital (e.g., 15% of assets) to secure the guaranty. So *VPLA*s have higher expected long-term payouts than guaranteed life annuities. Also, insurance company-issued life annuities typically promise their payment streams in nominal terms. So there is usually no inflation risk protection. In contrast, the assets backing *VPLA*s can be invested in inflation-linked assets which do provide inflation risk protection (e.g., infrastructure, inflation-linked bonds). In short, properly managed, the *VPLA* is a compelling alternative lifetime income provider to the traditional guaranteed life annuity.

Keith Ambachtsheer

Endnotes:

i. *See the BlackRock studies "**Read on Retirement**" (2023) and "**To Spend or Not to Spend**" (2023).*

ii. *US retirement services provider EMPOWER just announced the launch of an offering similar to BlackRock's. Also, an April 2024 article by MorningStar Research "**Target Dates and Annuities….It's Complicated**" confirms the challenges of integrating annuities into the Target Date Funds model.*

iii. *In fact, there were two pools, one with a starting payout based on a 4% hurdle rate, the other with a starting payout based on 7% hurdle rate. In the former case, the payout would be expected rise over time, maintaining real value; in the latter case the starting payout would be considerably higher, but would likely decline in real value over time.*

iv. *Kudos to the securities regulators for approving the launch of a mutual fund embedded with a longevity risk pooling protocol!*

v. *Saskatchewan's Plannera Pensions and Benefits organization also intends to add a VPLA option to the design of its Public Employees Pension Plan (PEPP).*

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