Plan members looking for a peaceful retirement need certainty that they will have a secure, long-lasting income in retirement. The authors explore the critical issues facing plan sponsors and how to implement a decumulation strategy within group savings programs.

HELP WANTED: Navigating Decumulation for Plan Members

by | **Pat Leo** and **Fraser Stark**

As the Canadian economy has expanded and grown more sophisticated over the years, capital accumulation plans (CAPs) have also evolved, with simplified matching formulas, the advent of target-date funds and consequently better-suited defaults. But where does this evolution take us next?

With a growing number of Canadians retiring each year, medical improvements extending lifespans for many and the declining availability of defined benefit (DB) pensions to Canadian workers (by 2019, those with DB pensions had fallen to under 10%[1] for private sector workers), the next important phase in Canada's economic evolution must be to help plan members achieve income security in retirement.

The current spectrum of decumulation options that plan sponsors face can be overwhelming. Taking the time to examine the fundamental reasons for helping retired employees through decumulation will help plan sponsors focus on the choices that offer the best advantage to their members.

Portfolio Management Won't Cut It

The uncertainty in income planning that affects plan participants and is brought on by longevity risk cannot be fully solved with portfolio risk management techniques. Regardless of the risk/return profile of the investment portfolio, a member in retirement is still forced to choose between spending at a higher level and risking running out of money or spending more conservatively, sacrificing goals they hope to achieve and risking leaving a significant portion of their nest egg unspent. (Of course, many choose to spend somewhere in the middle—but, unfortunately, this leaves them with a degree of each risk and does not fully solve the problem.)

"For people living in fear, moderation just doesn't cut it."

It's no wonder then that research has repeatedly shown that Canadians fear not having enough income in retirement as well as running out of money. There is an overlap between these groups, meaning many Canadians fear both.

Any approach offering 90% confidence that a member's income stream will last for 20 years is not an optimal outcome. Forget for a moment that a 65-year-old has around a 50% chance of living 25 or more years, or that a 90% confidence level leaves a 1 in 10 chance that the investor will run out of money during this initial 20-year period. The behavioural finance element means that even people who ultimately only live 20 years postretirement will likely have dramatically curtailed spending as they watch their savings deplete.

Takeaways

- Medical improvements have increased life expectancy, and the declining availability of defined benefit (DB) pensions to Canadian workers has put more pressure on investment options that could provide income security in retirement.
- Not all plan members can afford to leave behind a sizeable estate for their heirs. For many, deliberately choosing how much to spend in retirement and how much to bequeath should be a conscious and deliberate decision, not an unavoidable by-product of "fear of running out."
- Guaranteed retirement income comes with trade-offs. Some retired members will value and be willing to pay for guarantees on their lifetime income stream; others may prefer the higher expected income from nonguaranteed sources and accept some variability in income level to achieve it.
- When evaluating decumulation strategies within a savings program, consider priorities between income adequacy and investment sustainability as well as whether risk is increasing or decreasing over time.

To have a peaceful and confident retirement, plan members need complete certainty that their income will endure—however long they live.

"The best inheritance a parent can give their children is a few minutes of their time each day."

Have Your Cake, and Eat It Too

Leaving a legacy provides a powerful benefit to one's surviving family, but it is a luxury not all members can afford—or would necessarily choose. When a sizable estate is left behind, it can be easy to conflate a bequest motive with a protective one: a reserve fund designed to "self-insure" in case the investor lives to a very old age.

As Jens Soerlie Kvaerner writes in his 2022 paper in *The Review of Financial Studies,* it is essential to "separate bequest motives from precautionary saving motives […] because these saving motives can generate indistinguishable saving profiles over the life cycle."[2] For many plan members, deliberately choosing how much to spend in retirement and how much to bequest to surviving family members could lead to better outcomes. Leaving a sizable estate should be a conscious and deliberate decision, not an unavoidable by-product of "fear of running out."

No (Free) Guarantees in Life

In the January/February 2023 issue of *Plans & Trusts,* Mark Yamada asserts that "reliable income replacement is what most workers expect, need and want from a pension—even better if it is managed by someone else and guaranteed."[3] It's certainly hard to argue with that.

Guaranteed lifetime income is great, but—like everything—it comes with trade-offs. Off-loading market risk to others incurs a cost: In the case of lifetime annuities, that cost comes from the yield offered and the limited flexibility. By March 2023, the average lifetime annuity (ten-year guarantee) was yielding 6.64% to a 65-year-old Canadian male,[4] boosted significantly from recent levels by a series of interest rate increases pushed through by the Bank of Canada to tackle inflation. Even at this higher yield, analysis of one investment fund that incorporates longevity risk pooling into a balanced investment portfolio shows the expectation to provide an investor with 34% more income over their life.[5]

While some retired members will value and be willing to pay for guarantees on their lifetime income stream, others may prefer the higher expected income from nonguaranteed sources, accepting some variability in income level to achieve it. Investors should be able to select where they want to sit on this spectrum in the same way that CAPs allow them to during accumulation of an array of investment products.

But what do members want? Greenwald Research finds that workplace retirement plan participants in the United States are looking for more options, specifically those that generate retirement income for increased security: 85% of plan participants wish their employer's retirement plan offered an option designed to generate a stream of income in retirement. Consequently, the decision to include decumulation options is intensifying through industry associations. In November 2022, the Association of Canadian Pension Management (ACPM) released a paper titled *Decumulation 2.0: Converting Retirement Savings to Lifetime Income—A Prescription to Help Canadians Navigate Their Retirement Income Needs*. The paper proposes six calls to action, the fifth of which notes the following: "Provide Regulatory Guidance on Duties Relating to Offering Decumulation Options."

Built for Decumulation

With the winds of decumulation clearly upon us, the next critical question facing plan sponsors is how to implement a decumulation strategy within their group savings program. This phase requires purpose-built decumulation solutions. Let's explore five ways to implement a decumulation strategy along a scale of increasing effectiveness.

Provide Regulatory Guidance on Duties Relating to Offering Decumulation Options

As the competitive landscape for decumulation features begins to evolve and these are embraced by more and more plan sponsors as being in the best interests of their CAP members, CAP sponsors and administrators are looking for more guidance on how to govern them and manage their applicable obligations. ACPM recommends that industry decumulation regulatory guidelines be developed to clarify how CAP sponsors and administrators can manage duties associated with offering group decumulation options (e.g., VB, group LIF/RRIF, VPLA).

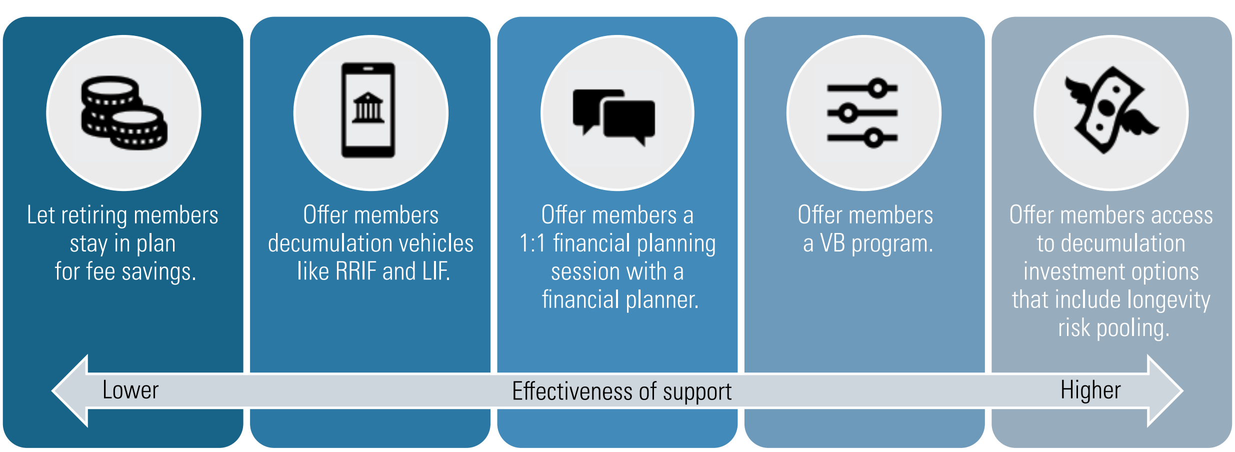
Source: Decumulation 2.0: Converting Retirement Savings to Lifetime Income—A Prescription to Help Canadians Navigate their Retirement Income Needs, ACPM, 2022.

Five Ways to Implement Decumulation Strategies Within a Savings Program

1. **Allow retired members to stay in the plan after leaving the company to take advantage of lower fees and high-quality management**. Don't underestimate the impact of fee savings: According to a recent Mercer survey, fee savings could translate to 12 more years of retirement income.[6]
2. **Offer in-plan registered retirement income fund (RRIF) and life income fund (LIF) options**. In addi-

FIGURE

Decumulation Strategies



tion to the fee benefits, allowing members to stay in the plan throughout the entire decumulation phase can increase overall plan assets (further reducing fees for all members).

3. **Provide financial planning sessions to retiring members**. Many record keepers now offer members access to some level of personalized financial planning. By considering the member's entire financial picture and personal situation, they can manage in-plan assets in a customized way. For retired members, this can involve creating a high-level retirement income plan.
4. **Establish a variable benefits (VB) program, allowing members to receive retirement payments directly from their defined contribution pension plan (DCPP)**. They are considered "variable" because a retired member can direct how much income is to be paid annually out of their VB account, subject to the minimum amount required to be withdrawn by the federal Income Tax Act (ITA) and the maximum amount as set out in the variable benefit regulations—just like a LIF.[7]
5. **Offer decumulation options incorporating longevity risk pooling**. Only by helping address plan members' longevity risk can a plan sponsor give members the confidence to spend during retirement. These investment options could include both guaranteed products (i.e., lifetime annuities) and nonguaranteed ones (i.e., variable lifetime income funds). The 2021 amendment to the ITA means this latter category now includes variable payment life annuities (VPLAs), an effective approach for more extensive plans but one that will take time to become a reality for members. Canadian options that are more broadly accessible today include two retail investment funds launched with longevity risk pooling.

Looking Forward

While CAPs now play an essential and expanding role in helping plan members prepare for retirement, we must ask ourselves why we offer plans in the first place: Is it to help members *save for retirement* or to help members *have a successful retirement?* For plan sponsors who strive to help their employees achieve their life ambitions even after they've left the company payroll, they will need to decide how their CAP decumulation strategy can most effectively support this.

BIOS

Pat Leo currently serves as vice president, longevity retirement solutions with Purpose Investments. He focuses on delivering innovative retirement solutions, thought leadership and dedicated service to institutional clients across Canada. Leo has more than 20 years of experience in financial services, defined contribution pension consulting, client management and business development at Mercer, Sun Life Financial and Sun Life Global Investments.

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Endnotes

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3. https://www.ifebp.org/members/pdf/planstrusts/2023/janfull.pdf#page=14.
4. CANNEX, March 1 2023; www.cannex.com/index.php/services/canada/annuity-products/income-annuities/.
5. The analysis considers the average of a range of modelled outcomes for the longevity risk pooling fund as well as the variability around the investor's expected lifespan.
6. https://www.mercer.ca/en/newsroom/mercer-retirement-readiness-barometer-2022.html.
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