As Canada’s defined contribution (DC) industry gains maturity, so do many of the members of DC plans. In fact, a growing wave of plan members is approaching retirement age. Some industry experts estimate that total assets expected to move into decumulation products over the next 10 years to be around $30 billion. This situation is prompting various stakeholders to shift their focus from accumulation to decumulation – or to at least give the latter phase more consideration than it has received in the past.

The question is how plan members can better ensure that their savings provide them with a reasonable retirement income that will last their lifetime. Two traditional answers spring to mind: a Life Income Fund/Registered Retirement Income Fund (LIF/RRIF) or an annuity. Traditionally, the choice has been viewed as an “either/or” one though, as we will see, a more balanced approach is likely to achieve better results. “Better”, of course, depends on the plan member’s particular situation and objectives.

RISK/REWARD VERSUS CERTAINTY

The choice between LIF/RRIF and annuity essentially depends on the member’s desire for fixed or variable income. A LIF/RRIF allows members to maintain their own investment portfolio. The member has more flexibility regarding income (subject to some minimums and maximums) and investments, and retains independence, but bears the investment and longevity risk – that being the risk of outliving one’s money. In contrast, an annuity guarantees a fixed income for life. However, annuities come with administrative fees, actuarial reserves, loss of independence and control, and typically will leave no money for beneficiaries, as there might be with a LIF/RRIF.

The challenge for members becomes how much to allocate to each of these traditional products to achieve their objective (and, for sponsors, how best to support members in their decision-making). Historically, most members have tended to choose the LIF/RRIF option. The oft-cited reasons are investment control and the availability of a death benefit to leave to beneficiaries. The main overlooked risk is outliving their assets - in fact, many retirees will argue that they chose a LIF/RRIF so that, if they die sooner than expected the insurance company won’t reap a windfall, but they give little consideration equal likelihood that they will have long retirements and could benefit greatly from longevity guarantees that annuities provide.

Some products have begun to emerge in the market to provide members with more of a “one-stop” option that combines a steady income stream with participation in the market and the potential for a residual death benefit. As well, a few large sponsors have developed their own offering to support their members during the decumulation phase. This article examines current decumulation options, compares them in terms of annual pension income and account balance at various levels of market performance, and makes recommendations for next steps.

CURRENT OPTIONS ARE LIMITED

There are few options presently available for pension decumulation:

- RRIF/LIF and/or an annuity
- Insurance company products
- Sponsor-developed solutions specific to their members
An overview of each option is summarized in the chart below. With respect to insurance products, the two widely-available options are generally similar and we have combined features to come up with a “generic” version. As for the sponsor-developed solution, we’ve cited the particulars of a decumulation product currently offered by one large Canadian university to its members. This university has seen a strong increase in membership growth since the product was introduced over 40 years ago¹ and will anecdotally point to former members who had initially transferred their assets out of the pension program at retirement, and who having spent a few years in the retail environment returned requesting to re-integrate their entitlements back into the program.

<table>
<thead>
<tr>
<th></th>
<th>LIF/RRIF</th>
<th>ANNUITY</th>
<th>INSURANCE COMPANY PRODUCT</th>
<th>SPONSOR-DEVELOPED SOLUTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>WITHDRAWALS</td>
<td>Flexibility, subject to increasing age-based minimum withdrawals, and, in the case of LIFs, maximum withdrawals</td>
<td>Fixed monthly payment</td>
<td>Payment equal to 5% of “base benefit” (amount contributed) at age 65; reduced if receive payment before age 65</td>
<td>Lifetime annuity with the payment amount adjusted annually to reflect investment and mortality experience of the pool.*</td>
</tr>
<tr>
<td>LONGEVITY RISK</td>
<td>May outlive savings</td>
<td>No risk of outliving savings</td>
<td>No risk of outliving savings</td>
<td>No risk of outliving savings</td>
</tr>
<tr>
<td>MARKET PARTICIPATION AND RISK</td>
<td>Full market participation and exposure to market risk, based on investments selected by the member</td>
<td>No market participation or exposure to market risk</td>
<td>Some market participation and exposure to risk:</td>
<td>Full market participation and exposure to market risk:</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Base benefit increased by 3% per year prior to retirement</td>
<td>• Monthly pension amount is adjusted once per year by difference between previous year’s actual rate of return in Balanced Fund, plus adjustment for mortality experience</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>• Step-Up Adjustment made at retirement</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td>• Guaranteed Benefit</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Base increased or protected, depending on market performance</td>
<td></td>
</tr>
<tr>
<td>RESIDUAL DEATH BENEFIT</td>
<td>Possible</td>
<td>Not possible</td>
<td>Possible</td>
<td>Not possible</td>
</tr>
<tr>
<td>COSTS</td>
<td>Low (generally investment management)</td>
<td>Medium (administrative, insurer reserves and profits)</td>
<td>High (administrative, insurer reserves and profits, investment management, additional guarantee costs)</td>
<td>Very low (investments pooled within pension program, no need for reserves or profit)</td>
</tr>
</tbody>
</table>

* Note that, this particular university offers members the choice of two interest rate bases at conversion, with adjustments based on the difference between returns and the selected basis. The member’s choice depends on whether they want an initial higher pension and lower one later, or vice versa.

¹ The RIF/LIF product was only introduced 10 years ago.
MAKING COMPARISONS

The above table highlights some of the different aspects of the various decumulation options currently available, all of which influence a member’s account balance and annual pension. To (somewhat) simplify our comparison of these products in relation to these two key elements, we considered a 60-year-old member with a balance of $500,000. We assumed that this member would like to target a starting annual income of between $20,000 and $30,000 per year, with some level of market participation and a residual death benefit. We then looked at three potential options:

- **50/50 Annuity/LIF** – The member uses half of their balance to purchase an annuity with the remainder invested in a LIF.
- **Insurance company product** – The member directs their entire balance to the insurer's product.
- **50/50 Sponsor/LIF** – The member directs half of their balance to the Sponsor option (4% interest rate assumption), with the remainder invested in a LIF.

For the 50/50 Annuity/LIF option as well as the 50/50 Sponsor/LIF options, we assumed the member would select a joint and 100% survivor form of pension (since insurance products typically provide surviving spouse income benefits). We also assumed that the member would withdraw as much as needed from their LIF (subject to legislated minimums and maximums) to achieve at least a level of overall income comparable with their initial goal.

Assuming a standard investment mix of 50% equities and 50% bonds for all LIFs as well as for the Sponsor balanced fund and the insurance product, we then ran a stochastic model with 1,000 scenarios to assess the impact of market participation/risk, as well as its effect on the member’s income stream.

RUNNING THE NUMBERS

We tracked residual death benefits and income levels for ages 60 to 90. We also looked at the median (Midrange) results of our projections, as well as those at the 90th percentile (Optimistic) and 10th percentile (Pessimistic). Our findings are summarized below.

MEDIAN LEVEL OF MARKET PERFORMANCE (MIDRANGE)

All three options provide a comparable residual death benefit after age 80, with the insurance product providing a much higher benefit for the first 20 years (age 60 to 80). In terms of income, the 50/50 Sponsor/LIF option was the clear winner with steady increases in income to over $40,000 per year after age 70, followed by the 50/50 Annuity/LIF option. The insurance product provides the lowest level of retirement income. With the likelihood of death prior to age 80 at about 30%, it appears that this type of product may be designed with too much emphasis on capital preservation in the member’s initial retirement years.
90TH PERCENTILE MARKET PERFORMANCE (OPTIMISTIC)

The story is very similar under strong market performance. All options offer a comparable level of residual death benefit after age 80, with the insurance product providing highest residual death benefits for the first 20 years. In terms of income provided, the 50/50 Sponsor/LIF option provides the highest level of retirement income. The 50/50 Annuity/LIF option and the insurance product provide a comparable level of retirement income, though significantly lower than the 50/50 Sponsor/LIF option, suggesting that the 50/50 Sponsor/LIF option does the best job of providing true market exposure and participation without sacrificing residual death benefits.
DRAWING CONCLUSIONS

It is encouraging to see some innovation in the decumulation space, but there is still room for improvement. Both insurance products seem to sacrifice too much retirement income in exchange for residual death benefits in the early years, with little longer term downside protection. The 50/50 Sponsor/LIF option shows that it is possible for a large sponsor to help members produce better decumulation results with an approach that provides true market participation, with reasonable fees and the benefits of pooling. Furthermore, by keeping the retirees’ assets in the plan, sponsors can reduce the fees to all members in their retirement program, given the larger asset base. However, such a product is only available to very few members right now, and is not for every plan sponsor, and members do need to be aware of the income risk associated with market participation.

This last point raises two important considerations: fees/costs and member communication/education. The fees associated with currently available decumulation products are highest for insurance products, largely due to the complexity of the structure they use, and lowest for the Sponsor/LIF solution. Those for the 50/50 LIF/Annuity approach fall in the middle.

As for member communication and education, this is a very real consideration for plan sponsors that opt to provide a decumulation solution and thus extend their relationship with their members for another 20 or 30 years. DC plan sponsors struggle with active member communication – do they really want to have to continue to educate members on investment strategies for the decumulation stage? Some large sponsors, like the Canadian university mentioned in this article, have accepted that challenge, believing that their commitment to their plan members extends through retirement.

FORWARD THINKING

One oft cited reason for why there are so few DC pension decumulation options in place in Canada is that pension regulations have not been helpful, with only British Columbia, Alberta, Saskatchewan and Manitoba allowing pension payments to be made out of DC pension plans.

However, the question of why the pension industry is not bringing more solutions to market is primarily due to lack of financial interest, and plan sponsor apathy. Insurance companies are generally quite pleased with retail-priced annuities or expensive roll-over programs being the go-to option for retiring plan members, and so, without a
real demand for innovation, few new solutions have been introduced. Outside of Canada, larger and more mature DC markets are beginning to see alternatives to annuities, such as income drawdown in the UK, where savings remain invested and the retiree “draws down” income from the fund, and a lifetime income strategy in the US, where savings gradually shift from target date portfolio to a secure income portfolio.

We hope to see continued innovation from sponsors and providers as Canada’s DC market matures. In the meantime, members retiring from a DC plan looking for a balanced mix of retirement income and market participation/residual death benefits should probably settle for allocating a portion of their assets to both traditional options – an annuity and a LIF/RRIF. Each option has strengths and weaknesses that seem to be offset quite effectively in almost any combination, producing better results than a 100% allocation to either option, or to one of the blended insurance products, without too much complexity.

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