FIDUCIARY CONSIDERATIONS IN OFFERING A LIFETIME INCOME FEATURE TO 401(K) PARTICIPANTS

by

Fred Reish, Bruce Ashton & Joe Faucher

REISH LUFTMAN REICHER & COHEN
ATTORNEYS AT LAW

11755 Wilshire Boulevard, 10th Floor
Los Angeles, CA 90025-1539
(310) 478-5656 / (310) 478-5831 [fax]
FredReish@Reish.com / BruceAshton@Reish.com / JoeFaucher@Reish.com
www.reish.com

June 2009

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Some insurance companies have begun offering features for 401(k) plans generally referred to as *<u>G</u>uaranteed <u>M</u>inimum <u>W</u>ithdrawal <u>B</u>enefits* – or "GMWBs." The GMWB feature is similar to an insurance policy: participants pay a fee to the insurance company in exchange for the insurance company's promise to pay the participant a guaranteed benefit in retirement equal to a percentage (usually 4½% to 5%) of the participant's account balance typically calculated as the total of their contributions, plus any market appreciation as of a specified date such as the participant's date of birth or investment anniversary (subject to certain adjustments described in this White Paper). The feature is typically tied to one or more specific investments, such as a lifestyle fund or a target date fund. The primary purpose of a GMWB feature is to provide participants with a minimum guaranteed income for their lives, regardless of how their investments perform and regardless of fluctuations in the market value of their account, provided they observe certain restrictions on the amount of the distributions they take.

The decision of whether to offer GMWBs to participants is a fiduciary one. This White Paper describes typical characteristics of GMWBs, addresses the legal standards that govern the fiduciaries' decision of whether to offer them, and discusses a number of the factors that fiduciaries should consider when making those decisions.

Not all GMWBs are the same. They have different price structures. They have different educational and communication materials which may make it relatively easier – or more difficult – for participants to understand how they operate and the restrictions they impose. They may or may not be transferable if, for example, the plan sponsor decides to switch to a new provider.

Before offering GMWBs and the investments provided by the underlying insurance company, fiduciaries should engage in a prudent process, considering all of the relevant factors. This White Paper provides fiduciaries with a starting point in a process to be used in deciding whether to offer GMWBs to their workers and, if they decide to do so, which GMWBs to offer.

INTRODUCTION

Policy makers, plan sponsors (and the fiduciaries of their plans) and participants have become concerned about whether employees will be able to live on their 401(k) accounts in retirement. The concern is twofold: will they have enough money when they retire? And will they withdraw it responsibly, so that they do not exhaust their accounts or IRAs before they die? This paper discusses a new generation of insurance products designed and marketed to address those concerns.

Research has shown that, if retired participants withdraw more that 4% or 5% of their account balance per year, there is a significant possibility that they will run out of money during their retirement. In light of this – and the lack of widespread acceptance of traditional annuity products – the 401(k) community and the investment and insurance industries have been working to develop other "solutions" that will enable retired participants to be confident that their money will last… in other words, a lifetime guarantee.

This paper examines the fiduciary considerations that 401(k) plan sponsors need to assess in order to make a prudent decision about whether to offer their participants a lifetime guarantee feature.

The most common approach is the "guaranteed minimum withdrawal benefit" or "GMWB," which enables 401(k) participants to buy, as an add-on to specified investments, a guarantee of an annual payment if a retired participant exhausts the underlying investments. The GMWB is analogous to an insurance policy that will pay the participant a specified benefit each year if the account is exhausted during the participant's retirement provided the participant withdraws no more than a specified amount (typically 4½% to 5%) each year. Unlike a traditional annuity, if the money does not run out, the remaining value of the investments can be left to the participant's beneficiary.

Not all GMWB products are the same; there are a number of different GMWBs with different features and premiums, but the general concept is the same. Before deciding whether to make a GMWB feature available, 401(k) plan fiduciaries owe a legal duty to their participants to consider the relevant factors, such as:

- The financial strength of the insurance company offering the feature, since the value of the guarantee is only as good as the ability of the insurance company to pay – many years in the future;
- The premium cost of the GMWB;
- The portability of the feature – this issue arises in a number of contexts, including portability by a participant to a different 401(k) plan if he changes jobs, the ability to continue the feature if the participant's benefit is rolled over to an IRA, and the continued availability of the feature if the plan sponsor changes providers; and

- The education provided by the insurance company so that participants can understand and decide whether it is appropriate for them – particularly with respect to the impact of withdrawals that exceed the guaranteed minimum.

These factors and others are discussed later in this paper.

The structure of this paper is as follows: first, we describe the general features of a GMWB. Then we explain the duties of fiduciaries under the Employee Retirement Income Security Act of 1974 (ERISA) and the process they must following in making and re-examining their decisions. Finally, we discuss the analysis that the fiduciaries should undertake in deciding whether to offer a GMWB.

TYPICAL FEATURES OF A GMWB

One traditional solution for lifetime benefits is an annuity, which may provide payments for life, for life with a guaranteed term (*e.g.,* 10 years) in the event of a premature death, or for the life of the participant with a survivor benefit for his spouse. A single life annuity will generally pay about 8% per year beginning at retirement age (*e.g.,* $24,000 a year on a $300,000 account balance). In that example, if an inflation protection feature is added, the initial payment would be reduced.

Experience has shown, however, that retiring participants are generally not drawn to annuities. It is not clear why that is so, even though there has been research on the subject, but there may be at least two reasons. First, life annuity payments stop at the death of the participant (and spouse in the case of a joint and survivor annuity). Participants may be concerned that, in the event of premature death, they will have overpaid for the annuity – that is, the periodic payments they receive will be less than the principal sum used to purchase the annuity. Further, when the payments stop, there is nothing left for the participant's heirs.

A relatively new product is the guaranteed minimum withdrawal benefit, or GMWB (sometimes also called guaranteed income for life, or GIFL). A number of insurance companies have begun offering this feature for 401(k) plans, and while they go by different names, they all operate similarly. The goal of a GMWB is to enhance the 401(k) plan participant's retirement security by offering protection against market losses and a guarantee that, if the participant follows certain rules, he will be able to continue receiving retirement income for life.

The following are the typical elements of the GMWB feature:

- The feature is generally tied to specified investment options offered by the 401(k) plan, generally a balanced investment portfolio such as a conservative, moderate or growth lifestyle fund, or a target maturity fund. However, the guarantee typically does not cover the most aggressively invested life style funds – because of the volatility, or riskiness, of those funds and the difficulty and cost of providing a guarantee when they are used. This is the case because the benefit payable to the participant is based on the value of the investment measured as of a specified date – sometimes referred to as the "benefit base." This base amount is initially the participant's account balance and it increases along with employee and employer contributions and investment earnings. As an added feature, the participant can "lock in" a benefit base on their anniversary or birthday. The benefit base, once "locked in," is typically not reduced by investment losses, although we understand some insurance companies have modified or eliminated this feature. The base amount is also not reduced by distributions to the participant in retirement so long as he does not take distributions of more than a specified percentage of the benefit base each year (usually 5%, if predicated on the participant's life, or 4½% in the case of a joint and survivor guarantee with a spouse). Thus, the base amount can go up, but not down, except for excess retirement distributions to the participant, loans and transfers to other investment options. (For ease of discussion, in this White Paper, we assume that the participant using GMWB has invested 100% of his plan account balance in the specified investment, though this is not required. Unless otherwise stated, we also assume that the participant retires and the distributions are post-retirement. We also use "account" to refer to both a participant's 401(k) account and a retiree's rollover IRA.)

> *Example:* A participant's balance on their anniversary or birthday (the "measuring date") is $100,000. Employee deferrals and employer contributions during the year total $10,000, and investment returns add another $7,000, making the account balance $117,000 at the end of the year. Assuming all other conditions are met, at the next measuring date the base amount will be $117,000. If, as of the year 2 measuring date, an additional $10,000 is contributed to the account but the account suffers investment losses of $13,000, the account balance at the end of year 2 will be $114,000, but the base amount used to calculate permitted withdrawals will remain $117,000. (This assumes that the participant is not taking retirement distributions and that the net loss takes into account the fee or premium paid for the GMWB feature and other expenses.)

- The participant is charged an annual fee – or premium – for this feature, which typically ranges from 35 basis points per year to 100 basis points and is in addition to the management fees for the investment. The fee, which is like an insurance premium, may be refundable (at least in part) if the plan sponsor switches providers. Some GMWBs may not include this feature; fiduciaries should be aware of this issue and evaluate it as a part of their deliberations.

- In exchange for this premium, the insurance company agrees to pay the participant a benefit equal to a set percentage (*e.g.*, 5%) of the base amount if the funds invested in the participant's account run out during the participant's retirement. If the participant's account is never depleted, the insurance company does not need to pay on the guarantee. And, if the participant dies before the account is exhausted, his remaining account balance is left to his beneficiary. However, the GMWB does not guarantee that the participant's account value will not be depleted; instead, it guarantees payments for life if the account balance <u>is</u> depleted. (Fiduciaries should consider whether the participant educational materials provided by the insurance company make this point sufficiently clear to be understood by the average plan participant.)

- To be eligible to receive the guaranteed payment, the participant must generally make premium payments for a minimum period set by the insurance company. This period is often 5 years and the qualification period is one of the factors that dictates the premium charge. (That is, if the period is shorter, the premium charge will generally be higher.) The payment of the premium continues for the duration of the guarantee, that is, until and unless the account is exhausted and, therefore, until the guaranteed payments commence.

- Beginning at retirement, a participant who elected the GMWB may withdraw from his account (which must continue to hold one of the specified eligible investment options) specified investment more than the set distribution amount (*e.g.*, more than the 5% per year), up to and including the entire balance in the investment. However, withdrawals in excess of 5% per year, regardless of the reason for the excess withdrawal, will reduce the guaranteed amount and result in reduced payments by the insurance company if the guaranteed benefit payments begin.

    Example: A participant has an account balance and base amount of $200,000. For five years after retirement, he takes yearly distributions of $10,000 (5% of the account balance). At the end of the five years, the account balance is $150,000, but the base amount is still $200,000. If in year 6, the participant takes a distribution of $15,000 (7-½% of the base amount), the base amount will be reduced on a proportional basis. Assume the GMWB reduces the benefit base and resulting income by a ratio of excess returns to the market value. In the example above, the difference between the 5% permitted distribution ($10,000) and the actual distribution ($15,000), is calculated as a percentage of the market value. The prior market value was $150,000 minus the guaranteed payout ($10,000) is $140,000. Next the ratio of excess withdrawal ($5,000) to market value ($140,000) is calculated: $5000 / $140,000 = 3.57%. Thus, at the end of the year, the base amount will be reduced to $192,857 ($200,000 – ($200,000 x 3.57%). The guaranteed payments will therefore be reduced to $9,643 ($192,857 x 5%). If the participant takes a distribution of more than $9,643 in subsequent years the guaranteed distributions will be further reduced.

In essence, the key feature of the GMWB is that it offers participants the opportunity to buy a guarantee of a specified annual distribution during their retirement, regardless of the performance of their investments. That feature, of course, is subject to restrictions – most notably, the restriction on the amount of the distributions that can be taken without reducing future guaranteed distributions. Distributions to participants in excess of that guaranteed amount may reduce the value of the GMWB feature. Consequently, to the extent participants will or may need to take larger distributions, it may be preferable for participants to take any distribution in excess of the guaranteed minimum from an account separate from the investment to which the GMWB feature applies.

CONSIDERATIONS FOR EVALUATING GMWBS

Whether to offer GMWBs or similar products to retirement plan participants is a fiduciary decision. What should fiduciaries consider when deciding whether to offer a GMWB feature? This is not a simple question, and there is no easy answer. Instead, as with any investment or product to be offered to plan participants, 401(k) plan sponsors (or the fiduciaries responsible for administering the plan) must engage in a prudent process in deciding whether to offer GMWBs to their participants. Once they make that decision, they need to analyze the specific GMWB to be offered. And as time goes by, fiduciaries must periodically re-evaluate (or monitor) the decision to make sure it continues to be valid. The standards by which the fiduciary's decision will be judged are governed by ERISA.

Before analyzing those standards, we should identify the fiduciaries of a plan, that is, the persons responsible for making decisions about GMWBs and the underlying investments. Under ERISA fiduciaries are identified largely by conduct, not title, except to the extent the plan or ERISA itself specifically gives that person discretionary authority or responsibility.[1] (The latter group would include the plan trustee, the "plan administrator" and any "named fiduciary.")

While plan sponsors are the primary fiduciaries, they often delegate the task of making decisions about their plans. This delegation may be to the members of a plan committee or designated officers of the company. In the typical case, a plan committee is responsible for making the fiduciary decisions about investments and plan features, like GMWBs. The essential point is that whoever makes the decision is a fiduciary and, as such, must follow certain steps in making the decision.

The Fiduciary Standards

The fiduciary's fundamental duties are the duty of loyalty and the exclusive purpose requirement. ERISA describes the duties as follows:

> "…a fiduciary shall discharge his duties with respect to a plan *solely in the interest of the participants and beneficiaries* and—
>
> (A) *for the exclusive purpose* of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan…."[2] [Emphasis added.]

The first of these obligations, to act solely in the interest of the participants and beneficiaries, is the duty of loyalty. The obligation to act for the purpose of providing benefits and defraying only reasonable expenses is the exclusive purpose requirement.

The fiduciary conduct in fulfilling these duties is measured by the "prudent man standard." To fulfill their duties under that standard, fiduciaries must act:

> "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and *familiar with such matters* would use in the conduct of an enterprise of a like character and with like aims…."[3] [Emphasis added.]

In other words, fiduciaries are required to act carefully, skillfully and diligently in carrying out their duties, and they must do so in the way a knowledgeable person would act in operating a similar enterprise (*i.e.*, a participant-funded and participant-directed retirement plan), taking into account changing circumstances as they evolve. The "knowledgeable person" standard means that fiduciary conduct is benchmarked against what a hypothetical person knowledgeable (about these types of products, *i.e.*, GMWBs) would have done. The focus is on conduct rather than results – what process did the fiduciary follow in making decisions?

This "prudent process" has been described by the Department of Labor (DOL) in a regulation that addresses investment decisions, though the process applies to any fiduciary decision:

> "With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirements of [the prudent man standard] are satisfied if the fiduciary:
>
> > (i) Has given *appropriate consideration to those facts and circumstances* that, given the scope of such fiduciary's investment duties, *the fiduciary knows or should know are relevant* to the particular investment or investment course of action involved…and
> >
> > (ii) Has acted accordingly."[4] [Emphasis added.]

This regulation lays out a number of steps in the fiduciary decision-making process:

- first, the fiduciaries must determine what information is *relevant* to the decision, both those facts and circumstances the fiduciary knows and those he *should know* to be relevant;
- second, the fiduciaries must obtain the information needed to make the decision through data gathering;
- third, the fiduciaries must evaluate the information; and
- fourth, the fiduciaries must make a decision based on the information that has been gathered and analyzed, that is, an *informed and reasoned decision*.[5]

In describing the prudent process (as it relates to investments) then Circuit Judge (now Supreme Court Justice) Antonin Scalia described a fiduciary's obligation as follows:

> "in short, there are two related but distinct duties imposed upon a trustee: to investigate and evaluate investments, and to invest prudently."[6]

That is, a proper investigation is the first part of the duty and results in the fiduciaries being informed. This in turn makes possible the second part of the duty – *i.e.*, prudent investment – because the decision to invest has a reasonable connection to the relevant information discovered through the investigation.

Stated slightly differently, the output of the prudent process is the making of an informed and reasoned decision.

The DOL has indicated that fiduciaries are not required to act alone but may rely on information provided by others. In Interpretive Bulletin 75-8, the DOL first asked:

> "In discharging fiduciary responsibilities, may a fiduciary with respect to a plan rely on information, data, statistics or analyses provided by other persons who perform purely ministerial functions for such plan…?"

The DOL then answered the question as follows:

> "A plan fiduciary may rely on information, data, statistics or analyses furnished by persons performing ministerial functions for the plan, provided that he has exercised prudence in the selection and retention of such persons. The plan fiduciary will be deemed to have acted prudently in such selection and retention if, in the exercise of ordinary care in such situation, *he has no reason to doubt the competence, integrity or responsibility of such persons.*"[7] [Emphasis added.]

In other words, a fiduciary may rely on others – like providers and advisors – to help gather and even analyze relevant information so long as the fiduciary has no reason to doubt the services of those persons or the credibility of this information.

One final thought about the prudence requirement. ERISA says that a fiduciary must act prudently "under the circumstances then prevailing." This means that when a fiduciary has engaged in a prudent process to make a decision, his work is not done; he must revisit his decision periodically, as circumstances change, to ensure that it continues to be a prudent decision for the plan and the participants. This is referred to as the duty to monitor, and this duty must be carried out in the same manner – using the same process – as the initial decision-making process.

In the next section, we discuss some of the factors that 401(k) fiduciaries should consider in deciding whether to offer a GMWB feature and, if so, which one.

Factors to Consider About GMWBs

The decision to offer GMWBs to participants is a fiduciary one. The plan sponsor (or the fiduciaries) must decide, using a prudent process, whether it is in the best interest of the participants to offer the feature and then analyze the details of the available products in the market to decide which one to offer. But what are the relevant considerations?

The following is not intended to be an exhaustive list but we suggest that, at a minimum, fiduciaries consider these factors in making their decision:

I. The Needs of the Participants and the Value of the Features Offered

Critical to the fiduciaries' decision are the needs of the participants. Court cases have said that fiduciaries must determine the needs of the participants, review the features and cost of the product offered by a number of different providers and select the provider whose service level, quality and fees best matches the plan's needs and financial situation.[8]

In this context, fiduciaries should consider:

A. *Is a GMWB feature appropriate for the workforce?* The fiduciary must consider the demographics of his plan's participant base. For example, does the plan cover older participants who are close to retirement – and who may lack the financial and investment sophistication needed to manage their distributions so that they do not run out of money? However, even if that is the case, at this time there is no fiduciary duty to offer long-term distribution guarantees to participants in 401(k) plans and there is no ongoing legal responsibility on plan sponsors or committees after participants have taken distributions of their account balances.

1. *Younger vs. Older Workforce.* These product features need to be considered in deciding on suitability of offering a GMWB. Consider, for example:

(i) History suggests that younger participants with a longer retirement horizon are more likely to be able to "ride out" downturns in the market (and their account balances). Therefore, as a group, younger participants may have less need for the guaranteed amount feature of a GMWB. At the same time, fiduciaries should take into account the impact on older workers who are nearing retirement of having downside protection on their investments, since their time horizon for recovering from market downturns is shorter.

(ii) Fiduciaries should assess whether it is appropriate for younger workers to pay the premium over a longer term, whereas it may be especially suitable for older workers to pay the premium for a relatively short period in order to obtain the guarantee. If the fiduciaries are concerned about the cost-versus-value equation for the younger participants, they may want to make sure that the provider adequately addresses that issue in communications with the participants.

(iii) Fiduciaries should take into account the impact on older workers who are nearing retirement of having downside protection on their future payouts, since their time horizon for recovering from market downturns is shorter. That is, while the GMWB does not protect the account value against investment losses, it does protect the participant against having to take lower distributions as a result of those investment losses.

(iv) Where required, the conservative to moderate asset allocation mix of the specified investments may also be inappropriate for younger workers who, arguably, should have their investments weighted more heavily towards the higher potential returns over the long term of equities.

(v) At the same time, older participants may be willing to select specified investment options with a higher percentage of equity investments – because of the guaranteed base. That could be viewed as a positive factor to be taken into account by the fiduciaries because it might assist the older workers in accumulating larger retirement savings.

2. *Investment Sophistication of the Workforce*. GMWB features are generally only available in connection with diversified funds that are managed by professionals, that is, lifestyle or target date funds. Fiduciaries should consider whether this is an advantage for the participants if the workforce consists largely of employees who lack investment experience. Regardless of how sophisticated the participants are, the fiduciaries should consider whether the materials describing the GMWB feature clearly and fully explain its features and restrictions and whether the explanation of the features is likely to be understood by the plan participants.

B. *Cost in relation to the features offered.* If the fiduciaries decide that offering the feature is appropriate, they then need to consider the features of the competing GMWB products in the marketplace. One of the fiduciaries' fundamental duties is to defray the plan's reasonable expenses. Thus, the cost to the participants of the GMWBs must be considered.

Cost, however, cannot be considered in a vacuum. While GMWBs are a relatively recent phenomenon in 401(k) plans, they vary in their cost and the range of features they offer. For example, some providers offer guarantees that the benefit base will increase even if the participant's account value decreases. Those guarantees may come with a higher fee relative to products that do not offer this type of guarantee.

In analyzing the cost of the GMWB feature, fiduciaries should also analyze the extent to which any part of the fee – or "premium" – paid to the provider by the electing participants is refundable if, for example, the plan switches providers after participants have elected the feature and paid the premium. Some providers offer refunds of the premiums paid over a period of years while others do not. In addition, the fiduciaries need to consider the "portability" of the feature. Suppose the participant terminates employment and rolls his benefits to an IRA. Will the GMWB feature follow the asset or does the participant lose the guarantee once he rolls his benefits over? (This issue is discussed in further detail below.) To be consistent with best practices, fiduciaries should consider whether the cost to the participant of the GMWB feature will increase, as it does in some products, if the participant "rolls" the investment and GMWB feature into an IRA.

II. Employee Understanding

The GMWB is not appropriate for all participants. For example, it is likely not a wise investment for younger participants to pay the guarantee fee over an entire career, whereas it may be reasonable for a participant who is within, say, 10 years of retirement to obtain the feature. Thus, the fiduciaries need to analyze a variety of factors:

A. *Does the insurance company provide education?* The fiduciaries need to determine the extent to which the insurance company will provide education to the participants about when it is beneficial – and when it is *not* beneficial – to buy the feature.

B. *Is the education effective?* Further, just insuring that the provider offers the education is not enough. The fiduciaries must also assess how effective that education is likely to be and then monitor its effectiveness thereafter to ensure that the steps being taken by the insurance company are accomplishing the objectives established by the plan sponsor for the feature.

C. *Do the participants understand all the features of the GMWB?* The fiduciaries should also be sure that participants who elect the GMWB feature receive clear information about additional factors such as the portability of the feature and the impact if they take distributions out of their investment that are greater than the guaranteed amount (*e.g.*, greater than 5% of the benefit base), which can cause the amount of the benefit base to be reduced. This could reduce – or eliminate – any value to the participant of the premiums paid.

III. Portability of the GMWB Feature

There are several issues regarding the GMWB's "portability" that fiduciaries should consider:

A. *Is the GMWB transferable if the employer switches providers*? This question is somewhat more complex than it may at first appear. Among the considerations a fiduciary must assess is whether the feature (and the premiums paid by participants) is lost if the fiduciary decides to change providers. Fiduciaries should analyze the extent to which the feature is transferable and consider the impact on the participants if it is not. If the feature is transferable, then the fiduciary should consider whether there are any costs that apply above and beyond the premiums already paid by electing participants.

   1. Once a provider is selected, the fiduciaries have an obligation to monitor that selection, *i.e.*, revisit the decision periodically to make sure it is still valid. It is possible that a fiduciary may decide that the services and investments offered by the current provider no longer meet the needs of the participants and may elect to change to a new provider, notwithstanding the fact that some participants may have purchased the GMWB feature. Those participants who have elected – and paid for – the GMWB may be dissatisfied if the GMWB feature is not transferable and/or if the premiums paid to date are not refundable. The issue thus arises whether the election of the GMWB by some participants will preclude the fiduciaries from making the decision to switch providers because of the resulting potential effect on those participants (because they paid for a feature which may no longer be available to them). If this were the case, the selection of the GMWB would arguably be a fiduciary breach because it would necessarily lead to a breach in the future – that is, the decision not to switch providers when it would otherwise be prudent to do so.

   2. The DOL has explained – in other contexts – that a fiduciary does not breach his duty simply because a decision adversely affects *some* of the participants. It is, however, a factor to be taken into account in making the decision.[9] The bottom line is that, to the extent the GMWB feature is not transferable in the event of a future switch of providers, the fiduciaries should be able to point to some rational basis for selecting the current provider despite the potential disadvantage to employees who could be adversely affected by a future switch in providers.[10]

B. *Is the GMWB transferable to another plan or an IRA, and at what cost?* Fiduciaries should consider the portability of the feature from one plan to another, that is, whether the GMWB feature is transferable if an electing participant leaves and seeks to transfer his account balance to his new employer. The extent to which the GMWB feature is transferable upon rollover of the participant's account balance to an IRA should also be analyzed. Some providers, for example, allow the participant to retain the GMWB feature upon rollover to an IRA maintained with that same insurance company. That feature provides some measure of protection to participants whose plans are terminated (thereby forcing the rollover of participant account balances). The costs of any allowable transfer should also be reviewed – as mentioned above, the cost of the GMWB feature may increase if transferred to an IRA.

IV. Financial Viability of the Provider

The primary value of the GMWB is the insurance company's promise that the participant will continue to receive income for life following his retirement, even if his account balance is depleted. That promise, however, is only as good as the insurance company making it. In selecting a GMWB provider, prudent fiduciaries must perform an analysis of the long-term financial viability of the insurance company, taking into account that if any payments are made under the guarantee, this will not likely happen for many years into the future. They are not required to use a crystal ball, but they should consider such things as the ratings given to the insurance company by the several ratings organizations (such as Moody's Investors Service and Standard & Poor's) and the reliability of such ratings, the makeup of the company's investment portfolios, the stability of management. In other words, the fiduciaries should use the lessons of the financial industry meltdown at the end of 2008 and beginning of 2009 as a measure of the appropriateness of selecting a GMWB provider.

V. The Duty to Monitor

The fiduciary's duty does not end when the GMWB is selected. Among other things, fiduciaries should periodically – at least annually – review whether there have been any changes in the information relied upon in selecting the insurance company and the investment to which the GMWB is attached to ensure that they remain appropriate choices for the participants.[11]

A. *Has the provider remained financially sound?* As noted earlier, in making the initial selection of the provider and GMWB, the fiduciaries need to evaluate whether the provider will have the financial ability to pay the guaranteed payments in the future. But as we have seen in the last months of 2008 and beginning of 2009, entities that were once thought to be sound are now in questionable (or even dire) financial condition. This means:

1. Under the "circumstances then prevailing" portion of the prudent man rule, the fiduciaries must continually monitor the financial viability of the insurance company using the prudent process described earlier in this paper, in an effort to ensure that the participants are not paying premiums for protection they will never

receive. The fiduciaries must engage in a prudent process to determine whether it is appropriate to remain with the insurance company that issues the GMWB. Fiduciaries who engage in that prudent process and determine that it is in all participants' best interest to switch providers should take that action, even if some participants have paid GMWB premiums. If they engage in that prudent process, the fiduciaries should not be liable for claims of breach of fiduciary duty by participants who paid for – and who may be losing – some of the benefit of the GMWB feature.

2. In addition, the fiduciaries must monitor the effectiveness of the provider's education programs with a view to whether it is fulfilling its obligation to inform the participants regarding the features and desirability in a given situation of purchasing the GMWB guarantee and the effectiveness of that program.

B. *Is the specified investment still sound?* A key element of the fiduciary's obligation to monitor is to review the plan's investments to determine whether any of them should be removed and replaced with others. This obligation applies to the specified investment associated with the GMWB feature. At a minimum, the fiduciaries should do the following:

1. Ignoring the GMWB feature, is the fund performing adequately in relation to established benchmarks and peer investments? If not, then it should be replaced with another fund or funds that meet the investment policy of the plan.

2. As a part of the analysis, however, the fiduciaries should consider whether other investment options offered by the provider will qualify as "specified investments" to which the GMWB feature can attach and make certain that the feature can be transferred from the option being removed to the replacement alternative. In fact, this issue is one that should be considered in selecting the GMWB provider and product in the first place, so that if it becomes necessary to remove the specified investment, there will be no question that it can be replaced with another to which the GMWB will attach.

VI. Other Issues

The fiduciaries should inquire into how the GMWB feature is impacted, if at all, in the event a participant is divorced and his account balance is divided pursuant to a QDRO. Does the non-participant spouse acquire enforceable rights to the guarantee? How is the premium to be paid in the future? If the spouse's benefit is distributed from the plan, does the guarantee continue to apply to the benefit? Does the carrier adequately address this issue in educational material provided to the participant – and to the spouse at the time of a divorce?

CONCLUSION

GMWBs provide potentially valuable benefits for 401(k) plan participants. They may provide a hedge against investment losses and provide a safety net of a guaranteed distribution in case the participant's own retirement funds run out.

Nevertheless, as with any investment or product offered to plan participants, fiduciaries must be careful to engage in a prudent, thoughtful process of gathering relevant information, assessing that information and making an informed, reasoned decision both about whether to offer GMWBs to their participants and about which of the GMWB products on the market to offer.

ENDNOTES

[1] ERISA §3(2`)(A)
[2] ERISA §404(a).
[3] ERISA §404(a)(1)(B).
[4] DOL Regulation §2550.404a-1(b).
[5] *See, generally, Riley v. Murdock,* 890 F.Supp. 444, 458 (E.D.N.C. 1995).
[6] *Fink v. National Savings and Trust Company*, 772 F.2d 951, 962 (DC Cir 1984).
[7] Interpretive Bulletin 75-8.
[8] *See, Liss v. Smith*, 991 F.Supp. 278, 300 (S.D.N.Y. 1998); *see also, Whitfield v. Tomasso*, 682 F.Supp.1287, 1304 (E.D.N.Y. 1988): "In providing … benefits, in order to fulfill their fiduciary duties, the [fiduciaries] should have considered the needs of the … participants and an appropriate level of benefits, and then should have solicited multiple proposals and completely evaluated the proposals before entering into an agreement."
[9] *See, generally,* DOL Field Assistance Bulletin 2006-01
[10] *See, generally,* DOL Field Assistance Bulletin 2003-3, describing methods for allocating expenses among participants' accounts and concluding that "… a method of allocating expenses would not fail to be 'solely in the interest of participants' merely because the selected method disfavors one class of participants, provided that a rational basis exists for the selected method."
[11] *See, generally, Liss v. Smith, supra*, 991 F.Supp. at 300.