Retirement Income—In-Plan vs. Out-of-Plan Solutions, Which Is Better?

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The defined contribution retirement plan model has replaced the defined benefit model plan as the employer preferred, privately funded, retirement plan for America's workers. Since participants are becomingly increasingly responsible for their own retirement planning, it is now recognized that a successful defined contribution plan must do much more than simply provide an attractive website and good investment choices. The plan must actually serve as a retirement *plan* to adequately replace the workers' paycheck for as long as they live in retirement.[1] In other words, defined contribution plans must function more like traditional defined benefit plans in order to improve the outcomes of plan participants.

In the average 401(k) plan only one in four plan participants (25%) will achieve retirement success—defined as having enough assets to match the future liability of their retirement costs.[2] This is a poor value proposition in relation to the amount of money spent to run 401(k) plans which can be quite expensive.

In the defined-benefit plan structure the employee was not required to make any decisions. Decisions such as whether or not to enroll in the plan, how much to save, how to invest the portfolio, economic assumptions, expected rates of return, expected inflation and most importantly the future benefit goal that was targeted were all done by professionals on behalf of the plan participants. In the defined contribution structure the plan participant must be their own economist, actuary, investment manager and consultant in order to achieve an adequate stream of income to finance the remainder of their lives. Not only must they make the correct calculations but they must also implement the actions that are required. Working against the participant is the high probability that they will not have the expertise to make the calculations and the presence of behavioral inertia in the form of disinterest, procrastination or simply feeling overwhelmed. Since plan participants face these barriers, even if they make the correct calculations, they rarely implement the required steps. These

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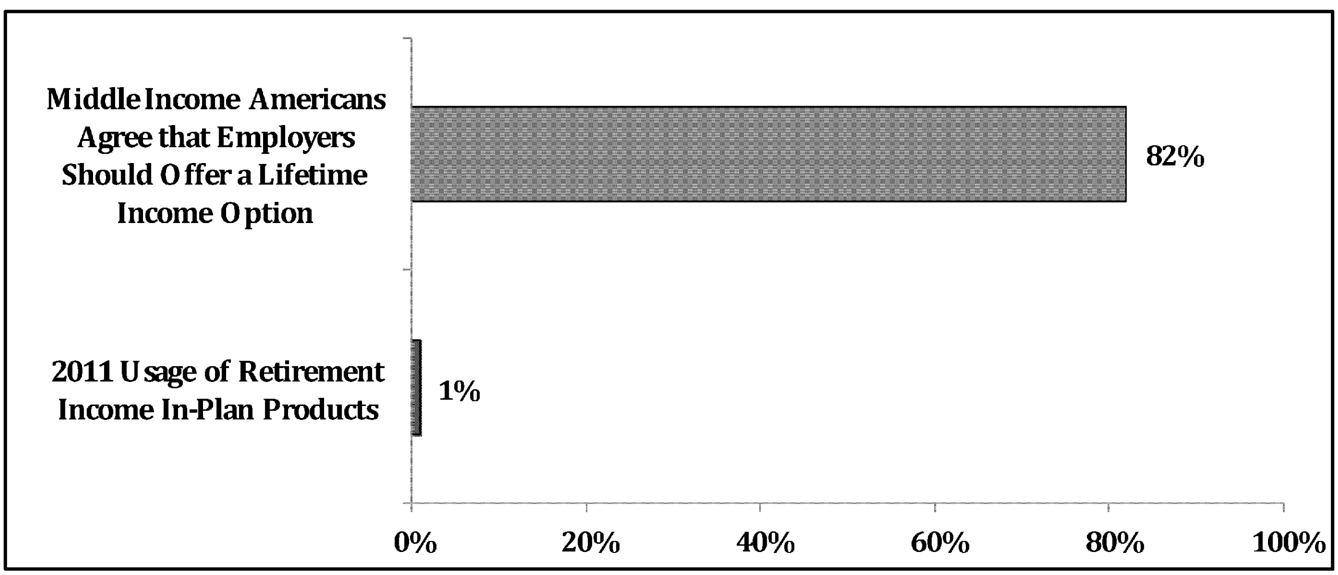
factors have historically produced the high failure rates in the traditional 401(k) plan.

Realistically, 401(k) participants face not one, but two immense challenges. The first, as described above, is to simply identify and then to remain on track for an adequate amount of asset savings sufficient to cover future liabilities. The second is how to take that savings and convert the lump sum asset value into lifetime monthly income sufficient to reliably replace their paycheck. Concerning the second challenge, the need for reliable retirement income solutions has become more evident each year. In addition to market risk and inflation risks which they've faced throughout the savings accumulation process, the retiree will now face the new risk of longevity. They do not know how long they will live nor what the future market returns will be. There is a large amount of uncertainty in trying to obtain retirement income security. The financial services industry has recognized this need and is attempting to respond with products engineered to deliver income. Some of these products are delivered within a qualified retirement plan ("in-plan" solution) and others are delivered outside of the plan; for example in a managed account or IRA structure ("out-of-plan" solution). The in-plan solutions can be stand-alone products or embedded in investments such as target date retirement funds. They can be offered in a guaranteed or non-guaranteed structure.

IS THERE REALLY A DEMAND FOR IN-PLAN RETIREMENT INCOME SOLUTIONS?

A dichotomy exists between the perceived demand of plan participants for retirement income and actual usage when the products are offered in the plan. Although some 82% of middle income Americans agree that "having a retirement income product in their plan is a good idea," less than 1% of plan assets are actually invested in the products when they are offered.[3]

Exhibit 1



The first mutual fund to provide guaranteed monthly income throughout retirement was the Blackrock LifePath Retirement Income target date fund. By replacing the traditional fixed-income asset class with a pool of unallocated deferred annuities, it was designed to automatically build retirement income alongside a growth portfolio. In theory, it was to be easily implemented, portable across record keepers and simple to communicate to participants. Despite a huge marketing campaign and the well established Blackrock name, since its launch in 2009 it has had zero plans sponsors adopt the fund. As of this writing it is not shown on the Blackrock website.

CONCERNS OF PLAN SPONSORS ARE MANY WITH IN-PLAN SOLUTIONS

The primary observed obstacles to inclusion of a lifetime income option in a defined contribution plan are at least fourfold: (1) plan sponsor fear of fiduciary status, particularly regarding uncertainty as to when a plan sponsor will be acting as a fiduciary; (2) the expenditure of time and resources needed to satisfy regulatory and other legal requirements for specialized products; (3) the lack of benchmarking and monitoring guidance for the new in-plan retirement income solutions; and (4) the risk of fiduciary liability for the failure of meeting participant expectations.

A recent survey study conducted by PIMCO identified many concerns by plan sponsors in addition to the significant fiduciary issues mentioned above.[4] Chief among those was the fear of insurance company default (perhaps many years into the future) and higher costs.

Exhibit 2

Plan Sponsor Concern	Total (N=32)	Percentage
Insurance Company Default Risk	27	84.4%
Higher Cost	23	71.9%
Lack of Transparency	21	65.6%
Fiduciary Oversight	19	59.4%
Lack of DOL Safe Harbor, No Regulatory Clarity	13	40.6%
Lack of Participant Demand	9	28.1%
Difficulty with Benchmarking and Monitoring	6	18.8%
Lack of Portability and Administrative Issues	5	15.6%
Selection Criteria	3	9.4%

REQUIRED IN-PLAN PRODUCT FEATURES THAT ARE STILL MISSING

Non Mandatory Solution: Many retirement income solutions require a long-term commitment on the part of the participant in order for that participant to experience the benefits of the solution. In some cases, early withdrawal or cancelation can be excessively wasteful for the participant. This is why, unlike an accumulation investment decision, the decision to participate in a retirement income solution should be an active decision on the part of the participant rather than a passive decision (such as defaulting). The DOL received many interesting comments (nearly 1,000) in their recent Request for Information on retirement income.[5] The vast majority of public comments were vehemently opposed to a mandatory system.

Diversify Insurance Carrier Risk: There is a need for multiple carriers to diversify the insurance risk. When a risk is protected by a counter-party (such as with an insurance product), prudence dictates that this risk should be spread across multiple insurance carriers, to the extent that this is feasible and practical. In addition a mechanism should exist to replace an insurance carrier if the plan fiduciaries deem it necessary, without disrupting the retirement income solution. This would, in essence, mitigate the risk associated with a potential insurer defaulting or becoming less credit worthy.

Portability: The American workforce has always been mobile and portability of in-plan retirement income solutions is a significant issue. There are two portability problems for the participant and one for the Plan Sponsor. One issue for the participant is the recordkeeping of the retained static asset after the employee has left the first company. The second issue is whether employees (and plan fiduciaries) can effectively monitor and manage small retirement income retained balances in multiple plans as they move from employer to employer over their working career. Individuals should be able to take their retirement income solution out of the plan if they wish. On the plan sponsor level, portability concerns can have the consequence of creating a substantial barrier in changing from one provider to the next as deemed prudent by that plan sponsor, retirement plan committee or trustee. The considerations regarding lack of portability of singular investments acquired by a few or less of the participants will now have to be vetted and discussed when making platform changes. This creates potentially new fiduciary risks.

Consolidating Product Rollovers: Currently, a major stumbling block for the in-plan solution is that employees cannot roll over fragmented income products into a single entity. The solution would be for the employee to be able to combine several retirement income products into a like kind "rollover" whereby they can combine with their current employer the other in-plan income accounts from prior plans. To avoid potential non-discrimination issues, and to comply with the benefits, rights and features rules, this must be done in a way that is actuarially fair or equivalent. The value of the combination rollover should be no less than the value of the prior individual parts. Today it is taken for granted that several IRAs holding traditional assets can be combined into a single large rollover. This does not yet exist in the retirement income industry because one insurer will not necessarily be providing the same benefit as another insurer, or use the same actuarial or interest rate assumptions. Until that happens portability will be a significant issue. No clear solution seems anywhere near on the horizon.

Fee Transparency and Reasonableness: When solutions are created and distributed to a large group, the group should benefit through lower fees. Ideally, natural economies of scale would occur meaning the buying power of the group would be better than that of an individual. Further, there should be clear transparency of both implicit and explicit fees. Fee transparency should extend to the discrete features of the solution similar to an a la carte menu. For instance, it should be clear what fee is being charged for investment management versus longevity protection. Once the fees are identified and clear, the plan sponsor can make a fair comparison across the alternatives available. In addition, it should explain which parties are being paid for providing which features within the product or solution. This will allow the plan fiduciaries to meet their obligation of fee reasonableness. Where multiple parties are providing benefits and collecting fees, cross-subsidies (if any) should be transparent. These products should be transparent enough that any participant could understand who and how much they are paying and what services they are receiving for their fee. Further, some fixed annuities do not carry an expense ratio and may offer many features and options for payments so it can be difficult to make an apples-to-apples comparison.

Survivor Options: We know that many people reach retirement as part of a couple rather than as individuals and, as such, consideration should be given in the solution design for options that allow income to continue (in whole or in part) beyond the life of the first-to-die of the couple. This would be a standard financial planning exercise for any couple using a financial planner. Why shouldn't it be part of one of these income solutions?

NEW REGULATORY GUIDANCE ON RETIREMENT PLAN LIFETIME INCOME OPTIONS

In 2008 the DOL issued its Annuity Selection Safe Harbor Review notice dealing with annuities in defined contribution plans. In 2012 the Internal Revenue Service and the Treasury Department released three areas of new guidance that aimed to increase the availability of annuities and other lifetime income options as forms of payment under defined contribution retirement plans. The guidance was issued to encourage plan sponsors to offer these lifetime income options in addition to lump sum payments that are particularly prevalent in defined contribution plans. The guidance was also aimed at helping with the issue of many retirees either outliving or underutilizing their retirement savings. This process was the initial step in a joint initiative between the Treasury Department and the Department of Labor to help increase savings and retirement income. Their goal is to provide incentives for retirees to move away from the current trend of taking lump-sum retirement plan distributions instead of annuity distributions.

Applying Survivor Annuity Rules to Deferred Annuity Contracts: Revenue Ruling 2012-3 dealt with the application of the spousal consent rules (qualified joint and survivor annuity or "QJSA" and qualified pre-retirement survivor annuity or "QPSA") to a defined contribution plan that offers a deferred annuity contract as investment option which is accounted for separately from other investment options offered under the plan. Although spousal consent does not come into play for purposes of the purchase of the deferred annuity contract, the ruling clarifies how the QJSA and QPSA rules apply once the participant has invested in the deferred annuity contract by using three scenarios distinguished by the features of the particular deferred annuity contract. In all three examples, the portion of a participant's account balance which is invested in options other than the deferred annuity is not subject to the spousal consent because the deferred annuity is accounted for separately from the rest of the individual's account.

Qualified Longevity Annuities: Longevity annuities provide retirees with a guaranteed stream of income for life beginning at an advanced age. The Treasury Department issued proposed regulations to address certain legal impediments to the offering of longevity annuities as a distribution option under a defined contribution plan. Participants can purchase these types of annuities with a small portion of their account balance and therefore insure against outliving their retirement savings. Before these new regulations, offering longevity annuities inside a defined contribution plan would generally have violated the required minimum distribution (RMD) rules of Code Section 401(a)(9).

The regulations tackle the limitations imposed by the RMD rules by creating qualified longevity annuity contracts ("QLACs") and providing that amounts invested in QLACs are excluded for purposes of the RMD rules. With a QLAC, participants would have the protection of additional retirement income later in life in case they "outlive" their retirement savings.

In order to qualify as a QLAC, the longevity annuity must meet certain specific requirements, including premium limits, a commencement date of no later than age 85, a death benefit for surviving spouses, being explicitly designated as a QLAC, and not having a cash refund feature. The proposed regulations would apply to contracts purchased on or after the publication date of the final regulations.

Rollovers to Defined Benefit Plans: Revenue Ruling 2012-4 provides guidance to employers who are willing to allow rollovers from their defined contribution plans into their defined benefit plans (including cash balance plans) with the ultimate goal of giving participants the opportunity to purchase additional annuity benefits under the defined benefit plan. Although these kinds of rollovers were not specifically prohibited in the past, there was very little supporting guidance available. The lack of specific guidance acted as a deterrent for allowing these types of rollovers. The guidance uses a model defined contribution plan to which joint survivor annuity rules do not apply and which does not permit after-tax contributions.

The annuity that becomes available under the defined benefit plan is the actuarial equivalent to the lump sum contribution rolled over from the defined contribution plan. In order to address issues raised by other defined benefit plan rules (e.g., Code Section 415(b) annual limit, Code Section 411(c) employee contributions being nonforfeitable), the IRS stated that the rollover does not violate such other rules if the defined benefit plan converts the rollover amount to an actuarially equivalent annuity by using the applicable interest rate and applicable mortality table under Code Section 417(e). Consequently, the benefit attributable to the rollover amount is treated as non-forfeitable and would not count toward the annual benefit limit under Code Section 415(b). The ruling applies prospectively to rollovers that are made on or after January 1, 2013.

RETIREMENT INCOME IS BEST DELIVERED AS AN OUT-OF-PLAN SOLUTION THAT IS PROCESS DRIVEN

In summary, because of the many difficulties with in-plan solutions as described in this article, it is the opinion of the authors that retirement income is best delivered as an out-of-plan solution that is process driven rather than product-centric. Each retiree has only one opportunity to retire; the planning and executing retirement funding should focus on that individual's unique set of facts and circumstances rather than historical data or group statistics. This is the fundamental difference between a "one size fits all" in-plan income product based upon a hypothetical person and the flexibility obtainable via an out-of-plan solution. Given the needs and unique situation of each retiree, retirement income cannot be distilled into a single "product."

Since future events are always unknown to individuals, the ongoing process must constantly monitor the potential surplus and the potential safety of the retirement nest egg while maintaining flexibility to be able to adapt to new circumstances as they arise. Success in retirement is achieved through a highly personalized process unique to each person's individual goals and circumstances. An out-of-plan solution will provide retirees and soon-to-be retirees with the confidence they need to fully enjoy the benefit of retirement knowing that their paycheck will be reliably replaced for the remainder of their lives.

Comparison of Current In-Plan Solutions with Out-of-Plan Solutions

Exhibit 3

	In-Plan Solution	Out-of-plan Solution
Location	In-plan	Out-of-plan
Customized	No	Yes, Personalized Financial Plan
Portability Problems	Several	None
Multiple Components[1]	Generally No	Yes, Optimized
Takes Into Account Other Assets	No	Yes
Income Floor Approach	No	Yes
Withdrawal Policy Statement ("WPS")	No	Yes
Asset/Liability Approach	No	Yes
Ongoing Checkups	No	Yes
Specialized Testing for Retirement Reliability	No	Yes
Flexible to Adapt to Changing Retiree Needs?	Generally No	Yes, Optimized
Ongoing Measurement of Safety and Funding Surplus	No	Yes
Quarterly Reporting Geared to the Retiree	No	Yes
Relief of Plan Sponsor Fiduciary Liability?	No	Yes
Is Solution Manager a Fiduciary?	No	Yes

1. Multiple components include consideration managed portfolios, time diversification, i.e., "buckets", Guaranteed Minimum Withdrawal Benefit ("GMWB"), longevity risk protection, dynamic asset allocation, and policy for harvesting of gains.

NOTES:

[1]Kasten, G. "The Defined Goal Retirement Plan," Journal of Pension Benefits, Autumn 2009, Vol. 17, No. 1, pp 23–44.

[2]Kasten, G. "The UnifiedPlan® Dramatically Increases Retirement Success and Improves Plan Cost/ Benefit Structure, July 2012, © Unified Trust Company, NA.

[3]Source: 2010 Wells Fargo Retirement Study.

[4]Exploration of Retirement Income Solutions and Issues, EBRI Policy Forum, May 7, 2009 Washington DC, Sponsored by PIMCO.

[5] http://www.dol.gov/ebsa/regs/cmt-1210-AB33.html.