

# Design Matters: Plan Distribution Options

Taking Money Out for Retirement



## Contributors

Jessica Sclafani, Cerulli Associates  
Rennie Worsfold, Financial Engines  
Doug Keith, GMO  
Elizabeth Heffernan, Hueler Income Solutions®  
Cynthia Mallett, MetLife  
Jim Smith, Morningstar  
Mark Fortier, NISA Investment Advisors  
Don Stone, Pavilion Advisory Group  
Tom Johnson, Retirement Clearinghouse  
Jody Strakosch, Strakosch Retirement Strategies, LLC  
Rachel Weker, T. Rowe Price Associates, Inc.  
Mark Foley, TIAA  
Kate Jonas, Nuveen  
Don Stroube, Wells Fargo



*Dedicated to Enhancing Retirement Security*

## OVERVIEW

The Defined Contribution Institutional Investment Association (DCIIA) believes that one of the primary roles of a defined contribution (DC) plan should be to create adequate retirement income for the plan's participants. Because people's financial needs in retirement can vary over time and from one person to another, it is important that a DC plan offer an array of retirement income and distribution options, providing participants with the flexibility they need (or want) after separation from active service.

DCIIA suggests that plan sponsors evaluate their plans' objectives with respect to retired/separated participants and then determine if the plans' retirement income and distribution options align with these objectives. Plans that seek to encourage plan participation through retirement may want to consider offering retiree-friendly options, including partial withdrawals and periodic payments, as well as products and services designed specifically to provide greater security, stability and sustainability of retirement income. (See **Exhibit 1**, "A Plan Distribution Lexicon: A Cerulli Associates and DCIIA Collaboration.")

### Exhibit 1

<b>A Plan Distribution Lexicon</b>		
A Cerulli Associates and DCIIA Collaboration		
<b>Common DC Plan Distribution Options</b>	<b>Prevalence</b>	<b>Objective</b>
<p><b>Single Lump-Sum (entire balance)</b></p> <p>Types of single lump-sums:</p> <ul style="list-style-type: none"> <li>Cash-out</li> <li>Direct rollover to another employer's DC plan</li> <li>Direct rollover to an IRA or rollover annuity</li> </ul>	High	Aligns with plan sponsor desire for separated participants to exit the plan
<p><b>Installment Payment Program</b></p> <p>A "systematic withdrawal plan" (SWP); also known as a "systematic withdrawal investment plan" (SWIP)</p>	Medium	"Retiree-friendly" (i.e., aligns with plan sponsor desire to retain separated participants in plan)
<p><b>Partial Withdrawals</b></p>	Medium	"Retiree-friendly"
<p><b>Qualified Plan Distributed Annuity (QPDA) with a Qualified Joint &amp; Survivor Annuity</b></p> <p>Types of in-plan annuities:</p> <ul style="list-style-type: none"> <li>• Immediate or deferred</li> <li>• Qualified Longevity Annuity Contract (QLAC)</li> </ul>	Low	"Retiree-friendly"

## KEY TAKEAWAYS

- As DC plans continue to transition from being a supplemental source of income for retired workers to becoming a fundamental one, DCIIA encourages plan sponsors to consider re-evaluating their plan distribution options in the context of their plans' current and emerging goals.
- A pivotal question for sponsors to answer is whether they want their plans to encourage plan participation to continue through retirement, or rather, to actively encourage distribution of assets once active service separation has occurred, either as a result of a job change or retirement.
- Plan sponsors' decisions about their plans' distribution policy can play a critical role in their participants' retirement outcomes. Plan sponsors, consultants and advisors are beginning to reconsider whether guiding participants towards lump-sum distributions, intentionally or unintentionally, through plan designs that encourage such distributions, is the most appropriate approach.
- Increasingly, plan sponsors have begun to realize that options such as periodic partial withdrawals, partial annuitization, monthly/quarterly installment payments and other flexible distribution strategies can allow retired and other separated participants to readily turn their account balances into the type of income stream that best meets their individual financial needs. In short, plan design (in this case, the distribution options available to participants, and the framing of those options) matters.

## INTRODUCTION

Since the passage of the Pension Protection Act of 2006 (PPA), the DC community has successfully elevated plan participation and levels of retirement savings. Even today, much of the DC community's attention has retained its original focus, centering around plan features that support wealth accumulation. However, we are now starting to see greater emphasis being placed on the needs of workers who are near and in retirement. Plan sponsors are increasingly reviewing how their plans allow and enable those participants to access their funds, in order to support them as they move past their primary working years.

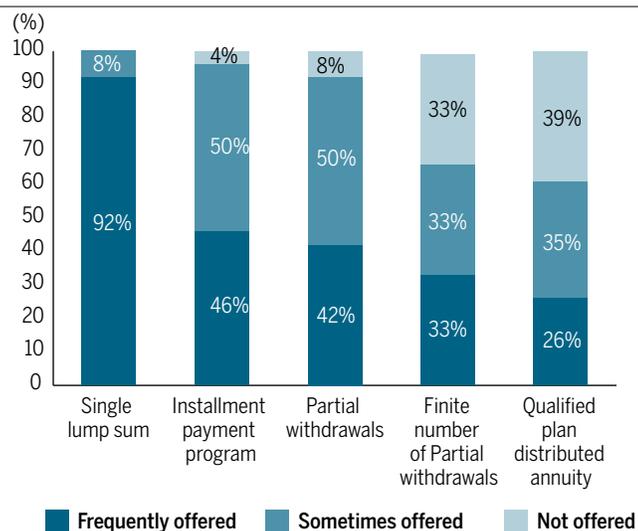
Clearly, plan sponsors' decisions can greatly influence participants' retirement outcomes. This paper highlights recent research that demonstrates the impact of plan design on participant behavior with respect to distributions. It also examines the various distribution options available to DC plan sponsors—in other words, the “rules” that determine how plan participants may access their accumulated retirement savings. With the exception of distributions that are mandated by regulatory policy or law, plan sponsors have significant discretion in designing a distribution policy for their plans.

## COMMON DISTRIBUTION PRACTICES TODAY

For the past 15 years, the single lump-sum option has been the most prevalent distribution method for DC plans, with 100% of DC plans surveyed in Alight Solutions' "2017 Trends & Experience in Defined Contribution Plans" reporting that they offered this option. In addition, the Alight Solutions report shows that 79% of participants utilize this distribution option.<sup>1</sup> When considered in the context of the DC plan's original objective – to be a savings vehicle for workers to supplement defined benefit (DB) plans with a well-defined retirement age – it's easy to understand why the lump-sum form of benefit distribution at the point of retirement has been so prevalent through the years. Collective research from Cerulli Associates and The SPARK Institute on plan distribution options reinforces and validates these observations. (See **Exhibit 2**.)

**Exhibit 2**

### Distribution Options Offered to Retired/Separated Participants, 2017



**Single lump sum:** One-time lump sum, paid in cash

**Installment payment program:** Systematic nonguaranteed withdrawals (e.g., monthly or quarterly remittance)

**Partial withdrawals:** Ad hoc withdrawals (i.e., take withdrawals as needed, without limitation)

**Qualified plan distributed annuity:** One-time lump sum converted to guaranteed monthly or quarterly payments

Sources: Cerulli Associates, in partnership with The SPARK Institute  
 Analyst Note: Survey participation included 26 recordkeepers representing \$4.5 trillion in DC plan AUA, nearly 452,000 plans, and greater than 69 million participants.

The Cerulli Report: U.S. Defined Contribution Distribution 2017—  
 Re-Evaluating the Use of CITs in DC Plans

Research also shows, however, that the retirement landscape has been shifting for some time now. Employer-based DC plans have become the primary retirement program for most working Americans today. Given this fundamental shift, DCIIA believes that it is time to review and re-evaluate DC plan distribution policies and options to ensure that they are well-aligned with the current and future needs of today's participants who have not yet retired.

### Single Lump-Sum Distributions Are Not the Only Option

Research indicates that when DC plans offer distribution options alongside a one-time lump-sum benefit payment, a number of retiring plan participants are interested in, and take advantage, of these options. For instance, Vanguard's 2016 report, "Retirement Distribution Decisions Among DC Participants," states that in 2014, 87% of the plans it administered required terminated participants to take a distribution of their entire account balance, even if a participant desired an ad hoc distribution. **Among the 13% of Vanguard plans that permitted partial distributions, simply offering them produced notably different participant behavior: about 30% more participants and 50% more assets remained in the employer plan when partial distributions were allowed.**<sup>2</sup> As Vanguard points out, "In other words, most retirement-age participants and their plan assets leave the employer-sponsored qualified plan system over time," but "this termination behavior [associated with lump sum payouts] seems linked to plan rules that inhibit ad hoc or flexible withdrawals from DC plans."<sup>3</sup> A subsequent Vanguard report, "How America Saves 2017," states that, by 2016, the percentage of its plans offering partial distributions had risen to 19%.<sup>4</sup>

Importantly, allowing participants the flexibility to remain in the employer-based retirement framework can have significant benefits, not only for plan participants, but also for plan sponsors. Retirees who elect to stay in the plan or who return to employment benefit from the plan's fiduciary standard of care, and maintain access to cost-effective, institutional investment offerings, often at lower cost than what is available to them in the retail marketplace. Moreover, all participants in the plan—no matter their age or how far from retirement they are—can benefit from increased economies of scale due to more participants remaining in the plan, which can further lower costs for everyone. At the same time, plan sponsors serving as fiduciaries also benefit from providing their plan participants access to lower fees that result from the greater asset levels.

Importantly, plan sponsors' views in this area are evolving. DCIIA suggests that all plan sponsors will benefit from periodically evaluating their objectives with respect to participants who have separated from active service. By conducting such an evaluation, plan sponsors work to ensure that distribution options are aligned with their goals for their plans.

#### Types of Single Lump-Sum Withdrawals

When plan participants take all their savings out of their DC plan at service separation, they generally can choose one of three ways to receive their distribution:

- **Cash-Out:** Depending on the tax status of the account, or sources within the account, the amount cashed out is generally subject to income tax by the IRS in the withdrawal year; if the account's owner is under age 59 ½, that amount may also be subject to a 10% withdrawal penalty. In addition, the participant's costs will mount if state and local taxes are due.
- **Direct Rollover to an Individual Retirement Account (IRA) or to a Rollover Annuity:** Typically, with this method, upon separation from active service, a participant's eligible distributions may be directly rolled over to an Individual Retirement Account (IRA). If the participant has requested a direct rollover, no taxes will be deducted from the transfer amount.
- **Direct Rollover to Another Employer's DC Plan:** An increasing number of plan sponsors welcome "roll-ins" from other qualified DC plans. A participant leaving one employer may therefore have the option to take a required plan distribution in the form of a rollover to either a new employer's plan or, in some circumstances, a plan maintained by a former employer of the individual. No taxes will be deducted from this direct rollover.

#### RECONSIDERING AND UPDATING PLAN OBJECTIVES AND DESIGN

A growing number of plan sponsors and consultants are beginning to re-think their plans' core purpose and design. **According to the MetLife 2016 Lifetime Income Poll, 85% of plan sponsors now believe that retirement income should be the core purpose of a DC plan; four years earlier, only 9% of plan sponsors held that opinion.** Furthermore, in responding to the poll, 96% of plan sponsors also said that they support adding at least minimum lifetime-income information (i.e., conversion of account balances into a monthly income stream) to DC plan benefit statements.<sup>5</sup>

It is also clear that increasingly, plan sponsors and consultants are reconsidering whether intentionally or unintentionally guiding participants toward lump-sum distributions is the most appropriate approach for their plans. PIMCO's 2017 "Annual Defined Contribution Consulting Support and Trends Survey" shows that on average, "Fifty-five percent of consultant's clients either actively seek to retain clients' assets (21%) or prefer retaining these assets but do not actively encourage retention (34%). Only 13% of the plan sponsor clients surveyed prefer retirees to move their assets out of the plan."<sup>6</sup> Additionally, according to the MetLife 2016 Lifetime Poll, nearly eight in ten plan sponsors (79%) think that allowing plan participants to take a partial lump-sum *and* a partial annuity from a DC plan is preferable to a plan design where participants must take their entire account as *either* a lump sum *or* an annuity.<sup>7</sup>

Data from a further variety of sources also indicates that many plan sponsors are re-considering their plans' objectives and distribution design and features. Yet, the research on how plan sponsors approach distribution options suggests that many of them have not yet worked to align their distribution methodology and plan design with their evolving plan objectives. Understandably, in light of changing demographics and objectives, plan sponsors may want to seek guidance on how to refine outdated distribution rules.

To aid plan sponsors in determining their strategic objectives with respect to participants' post-retirement benefit distribution options, sponsors should consider how they would answer the following questions:

- Do you want to keep retired and/or separated participants' assets in the plan?
- Does the plan currently have, or should it have, an overall retirement income objective--for example, an income-replacement goal?
- Does the plan want to provide solutions for participants so that they will be able to create a retirement income stream for themselves?
- Is the goal to have those who separate from service for any reason--or only those who do so due to retirement--remain with the plan? If the latter, is there interest in offering account consolidation (through roll-ins) or aggregation, so that participants have an opportunity to collect all (or most) of their qualified assets in one plan?

- What distribution options do you believe should be considered for those separating from active service, even if the sponsor's preference is to limit the plan only to those actively employed?
- What guidance or advice do you want to offer or make available to participants about their choices and options?

After plan sponsors have determined their plans' overall objective, they should review plan documents to identify which of the current distribution options align with their revised objectives. Plans operating and intended solely as supplemental savings vehicles may prefer to limit their distribution options, or perhaps favor offering only the full-withdrawal option for retirees. Plans intended to ensure retirement income, such as those where a DB plan has been phased out or terminated, may instead want to consider other distribution options, ones that enable the participants to use the plan after separation from active service, thereby helping them to meet their income needs and spending priorities through retirement.

Additionally, with plan sponsors increasingly attuned to the fiduciary risks associated with their retirement plans, it is also important to note that a distinction should be drawn between those actions which are within the fiduciary framework, and those which are not. For example, the process of designing the plan and deciding what benefit payment forms will be included are typically considered to be "settlor," rather than "fiduciary," actions. Implementing features, such as specific products or provider selection, should be done with the normal standard of care for a fiduciary.

## RETIREE-FRIENDLY DISTRIBUTION PROGRAMS

Sponsors interested in ensuring that their plans provide income streams for retiring participants will want to consider "retiree-friendly" distribution strategies. Such strategies are likely to offer flexibility around timing (providing a choice for distribution frequency, such as monthly or quarterly), as well as amounts distributed, and partial (ad hoc) withdrawals. Such distribution options can be very helpful in supporting a plan's participants as the latter develop a roadmap to meet their retirement spending objectives from across their various accounts.

Flexible benefit-payment choices, such as periodic partial withdrawals, partial annuitization, monthly/quarterly installment payments and other options, allow these participants to turn their account balances into income streams that meet their individual financial needs while continuing to support investments for their future goals, funds permitting. It is important to remember that plan participants are often trying to figure out how to convert their "nest egg" into something similar to the paycheck they are accustomed to receiving from their employer (as shown in **Exhibit 3**). Knowing that they have the capability to stop and start payments also provides participants with a highly beneficial flexibility, so that they can manage both expected and unexpected spending needs.

As with any new paradigm, plan sponsors will benefit from guidance when it comes to implementation of their goals—working as needed with their counsel to amend their plans, with their advisors to update plan policy statements, and with their recordkeepers and other service providers to ensure that their plans' infrastructure and providers can support these provisions.

### Exhibit 3

#### Topics Considered Most Important When Planning for Retirement

Topic	All Participants (%)
Healthcare expenses	49.8
Developing monthly income from my investments	44.3
Social Security	44.1
Understanding whether I will outlive my money	35.2
Evaluation of whether I am saving enough	35.1
Ways to guarantee portions of my income	32.8
Leaving a legacy to future generation	14.8
Other	1.0

From "The Cerulli Report: U.S. Evolution of the Retirement Investor 2017—Rollovers and Post-Fiduciary Rule Retirement Advice"

Analyst Note: Respondents were asked to select all applicable options. Survey participation included 1,000 active 401(k) plan participants.

Source: Cerulli Associates

## Types of Retiree-Friendly Distribution Options

### *Partial Withdrawals*

Partial withdrawals allow participants to make periodic withdrawals from their accounts, as they need access to the assets. It is important to note that by partial withdrawal we are referring to ad hoc, one-time withdrawal requests, rather than the periodic withdrawals at regular intervals that characterize an installment payment program.

Some plans require all withdrawals to be funded proportionally across the participants' plan investment options ("pro-rata"). Plans can promote further flexibility by allowing participants to choose the plan investment options that will fund their specific withdrawal requests, or by designing the investment menu with cash flow objectives in mind.

### *Installment Payment Programs*

Often referred to as a "systematic withdrawal plan" (SWP) or, "systematic withdrawal investment plan" (SWIP), these installment payment programs can provide a somewhat more defined approach to spending down a retirement account balance, as opposed to taking ad hoc withdrawals whenever needed. An installment payment program allows a retiree to choose a specific payout amount (in dollars, or as a percentage of the balance) to be made at predetermined intervals, such as monthly, quarterly, semiannually or annually. This regular, periodic payment method allows participants to create an income stream in retirement. It is not an income stream that is guaranteed to last for the participant's lifetime; it will continue until the account has been depleted, which may occur while the participant is still living.

For additional flexibility, provisions can also be designed with the ability to start, stop and restart installment payments. Such flexibility should also allow retirees to select the funds from which their assets would be withdrawn. Currently, to the extent that installment payment programs are available, they tend to draw from all plan investments, not just from a select set of investments; any changes to this would need to be discussed with the plan's recordkeeper.

Plan sponsors may also wish to consider whether technology enhancements or present direct-deposit programs are available to facilitate the functions of recordkeepers and the custodial banks with whom they work to direct recurring withdrawals to participants' bank accounts.

### **Annuities as a Form of Distribution**

One method a DC plan participant can employ to convert all or some of their account balance into a guaranteed income stream is to purchase an annuity. Income annuities, whether immediate or deferred, create an income stream that cannot be outlived, but are also therefore uniquely able to provide guaranteed income for life. Annuities may be offered as a plan distribution option known as a Qualified Plan Distributed Annuity (QPDA) or, if that is not an option, can be offered by rolling the funds needed for the annuity from the plan into an IRA, which is then able to facilitate the conversion to income.

In addition, over the past decade, many industry providers have offered in-plan accumulation income programs that incorporate a group annuity contract and therefore, thereby providing some form or amount of guaranteed lifetime income payment when the participant retires. (For more on this, please see the 2015 DCIIA paper, "Retirement Income Solutions: A Guide for Plan Sponsors"). These options include:

**Immediate or deferred annuity:** When a plan offers this distribution option, a participant may purchase an annuity from an insurer that makes periodic payments. The income payments can begin either within 12 months (this is known as an "immediate annuity"), or at a later date--typically three to five years later (this is known as a "deferred income annuity"). Such annuities might be attractive for a participant who wants a secure income but does not want to begin retirement benefits yet.

### **Qualifying Longevity Annuity Contract (QLAC):**

Introduced by the Department of the Treasury and the Internal Revenue Service in 2014, a QLAC provides the participant with the opportunity to purchase, within defined limits,<sup>8</sup> a very simple, inexpensive deferred income annuity that will guarantee income at older ages. This enables participants to adopt a spending plan for their savings until their average life expectancy, and to have an income guarantee if they live longer than the average. Typically, these income payments begin by age 85.

Finally, there is one additional option for annuitization available to the small number of plan sponsors with both active DB and DC plans for the same population. Some of these plan sponsors permit DC plan participants to consolidate their DC account balance into the DB plan of which the participant is also a member. The “Callan Institute Survey of 2017 Defined Contribution Trends” reports that 27.4% of plans offer it.<sup>9</sup> With this option, the participant’s assets are transferred to the employer’s DB plan. Participants then use these amounts to purchase additional amounts of guaranteed retirement income through the DB plan, generally at rates preferable to those available in retail annuities.

Notwithstanding the evolving selection of annuity designs and the increasing array of service providers offering or supporting them, annuity-based forms of benefit payment for private 401(k) plans are not expected to be broadly adopted until the annuity carrier selection safe harbor rules are clarified to a degree comparable to the one that now exists for securities-based accumulation options. In fact, according to Alight Solutions, as of 2017 only 18% of DC plans offer any form of access to an annuity, and numerous research reports show that the fiduciary safe harbor is the most significant reason.<sup>10</sup>

## EDUCATING PARTICIPANTS ABOUT THEIR RETIREMENT CHOICES

Educating plan participants about the pros and cons of all the options available to them through their DC plans’ distribution strategies is critical in helping them to understand the implications of the choices they will make. Engaging participants is a key driver of improving financial wellness and decision-making over all phases of plan participation, but it is particularly important when guiding those approaching retirement, as well as retirees who are still in the plan. When plan sponsors who are tasked with communicating and presenting retirement choices to retiring or near-retirement participants are themselves armed with an understanding of the behavioral challenges that often affect those participants, they can better help educate employees. These plan sponsors are better able to accurately frame participants’ choices, guiding them to overcome the known behavioral challenges.

## Checklist for Plan Sponsors

1. Identify current “money out” options by reviewing the plan document.
2. Check whether the plan allows for partial withdrawals.
3. Evaluate whether the plan’s current options align with your goals and objectives for your plan’s future.
4. Request an analysis of the actual participant distribution history from your recordkeeper in order to identify what current participants have been doing with their accounts; also examine your demographic data to estimate how many participants will reach retirement age in the next 5, 10 or 15 years.
5. Consider incorporating retiree-friendly distribution features and determining what plan document changes would be required to introduce such features.
6. Evaluate the treatment of beneficiary payments and whether the only distribution option is a lump-sum withdrawal.
7. Consult with your recordkeeper to determine their best practices and what is possible for your plan.
8. Communicate distribution enhancements to your participants.

## CONCLUSION

Prudent plan sponsors focus on ensuring that their plans’ designs support their plans’ objectives and are aware that both the former and the latter can change over time. DCIIA believes that retirement income adequacy should be one of the primary goals for DC plans today, given that participants increasingly rely on their accumulated DC assets to provide them with an income stream in retirement. DCIIA therefore recommends that sponsors look at the tools and guidance their plans’ service providers currently offer their retirees and near-retirees, to determine how they may be influencing their distribution decision-making. Together with enhanced participant education for pre-retirees and retirees, plan design can be evaluated, and in most cases, changed, to include a greater range of flexible distribution options. With the proper tools, participants are then better empowered to construct retirement income streams that meet their unique needs, affording them the control and certainty they need to achieve a dignified and sustainable retirement.

## Endnotes

<sup>1</sup>Alight Solutions, "2017 Trends & Experience in Defined Contribution Plans," 2017.

<sup>2</sup>Jean A. Young, "Retirement distribution decisions among DC participants," Vanguard Research, The Vanguard Group, October 2016.

<sup>3</sup>Ibid.

<sup>4</sup>Jean A. Young, "How America Saves 2017: 2016 defined contribution plan data," The Vanguard Group, June 2017.

<sup>5</sup>MetLife Lifetime Income Poll, "Perspectives of Defined Contribution Plan Sponsors on Regulatory Developments," 2016.

<sup>6</sup>PIMCO 11th Annual Survey Highlights 2017, "Defined Contribution Consulting Support and Trends Survey," 2017.

<sup>7</sup>MetLife Lifetime Income Poll, "Perspectives of Defined Contribution Plan Sponsors on Regulatory Developments," 2016.

<sup>8</sup>QLAC tax rules allow participants to use the lesser of 25% of the account balance or \$125,000 for their QLAC, and to carve out the amount used from application of the Required Minimum Distribution Rules which would otherwise apply.

<sup>9</sup>Lori Lucas, Jamie McAllister and Thomas Szkwarla, "Callan Institute Survey: 2017 Defined Contribution Trends, 10th Anniversary Edition," 2017.

<sup>10</sup>Alight Solutions, "2017 Trends & Experience in Defined Contribution Plans," 2017.

## ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of American workers. Toward this end, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution outcomes. DCIIA members include investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants.

For more information, visit: [www.dciia.org](http://www.dciia.org).