The Evolving DC Plan - From Accumulation to De-accumulation

Background

Organizations offer employee benefit plans as tools to achieve both organizational (employer) goals and individual (employee) goals. Human Resource managers along with their CFOs work to continuously improve their compensation structures and benefit plans to ensure they meet the needs of the organization to attract, retain and manage their most critical asset: their people. The premise is that better benefits will better engage employees and motivate them to reach peak performance. Retirement plans represent an important factor in this equation. However, employer-sponsored retirement plans have become so ubiquitous that they're now seen as table stakes; the top employers need to find new ways to differentiate their benefits by meeting employees' evolving needs. Today's employees have greater demand for products that can help them not only to save during their working years, but also to draw retirement income after they retire. An organization's willingness to offer such products will enhance their ability to attract top talent. With this as our supposition, we foresee one of the next evolutions of plan design will be the distribution options offered by employers to their employees as part of their defined contribution (DC) plans. More than ever, DC plans need to look at de-accumulation products and strategies for their participants. De-accumulation strategies can advance the employer's goal of effectively managing their human resources, by motivating high performance and enabling orderly, "on time" retirement, while giving their employees access to good, institutionally priced products and services.

Demographic trends

Several factors and demographic trends in motion are compelling employers to re-look at the distributions options they offer to participants within their DC plans. Some of these include:

- Just 20 years ago, DC plans were a supplement to retirement security with DB and Social Security as the primary retirement plans. Today, the DC plan is becoming the largest financial asset for many employees / participants as the result of several factors.
    - The Social Security system faces insolvency, with its Trustees projecting funds will run out by 2034 (source: www.ssa.gov).
    - Defined benefit (DB) plans are declining, if not disappearing all together– especially outside of the government space-- causing the DC plan to be the primary source of retirement security.
    - Today 71% of employed workers say they have access to employer-sponsored retirement plans, and 83% of eligible employees contribute to them.[1]
    - According to a study from Willis Towers Watson, nearly 80% of workers say they will rely on their employer-sponsored retirement plans as their primary retirement savings vehicle.[2]
    - Savings outside of DC plans within the U.S. is lower than most other developed countries.
    - Home values are low, limiting the use of home values as a retirement security tactic.
- Approximately one in four 65-year-olds today will live past age 90, and one in 10 will live past age 95 (source: www.ssa.gov). With increasing longevity comes an increase in the number of years the average American will need to plan for retirement income.
- Low interest rates have challenges with traditional approaches like bond laddering and fixed annuities.

Going forward, the DC plan will be the primary plan employees use to secure their retirement. Employers are faced with the challenge to determine if and how they want to offer assistance to their employees. Because we see mutual benefits

[1] [1] EBRI Retirement Confidence Survey.

[2] PLANSPONSOR Magazine, http://www.plansponsor.com/Employees-Willing-to-Pay-More-for-Retirement-Benefits/

to both the employee and the employer, we believe de-accumulation strategies are the natural next step in the evolution of retirement plan offerings.

Regulatory trends

Several regulatory initiatives have nudged both employers and employees to rethink (or to think for the first time about) de-accumulation strategies from DC plans. Some of these proposed regulatory initiatives and finalized regulations include:

- FINRA Regulatory Notice 13-45 -Reminder on rollover Practices to B/Ds regarding sales practices, conduct and analysis on suitability, causing Broker / Dealers to increase their oversight on rollover practices to ensure a rollover IRA is in the participants best interest
- FINRA's Tips to participants on Rollovers that state there can be certain conflicts of interests between the investor and the financial intermediary – giving pause to some participants on the rollover decision and keeping assets in qualified plans
- GAO report on Rollovers in which Labor and IRS could improve the rollover process for participants between and among retirement plans
- SEC examination priorities and guidelines will step up review of rollover practices
- DoL may re-issue proposed regulations on annuity safe harbor to provide clearer guidance on annuity safe harbors that have already been issued
- DoL Advanced Notice on Proposed Rulemaking – proposed that DC balances should be projected to age 65 on quarterly statements with those projected balances converted to annuities / income streams on DC statements; this may cause DC plan participants to view their DC plan as a drawdown vehicle in addition to an accumulation vehicle
- DoL conflict of interest / definition of fiduciary regulation will require virtually every intermediary to become a fiduciary and receive only reasonable compensation when suggesting or recommending a rollover transaction requiring significant additional due diligence and disclosures causing disruption in the rollover / Individual Retirement Account (IRA)marketplace. This could cause rollover transactions to be increasingly more difficult due to fiduciary status even under expanded Prohibited Transaction Exemptions

Our regulators seemingly have a preference that retirement assets stay within the qualified plan marketplace, in which plan sponsor fiduciary oversight would enable most participants to receive good value, lower fees and, in many instances, institutionally priced de-accumulation products and services--which are generally either not available or are more expensive in the retail space. It is common practice for many participants nearing retirement to roll out of qualified plans and consolidate assets with a trusted advisor. This current “norm” is a strong force and will continue for many participants despite the regulatory efforts to promote DC plans as accumulating and de-accumulation vehicles. However, the demographic and regulatory trends mentioned above are causing all parties—including DC service providers, advisors, consultants, plan sponsors and plan participants—to better utilize the DC plan as a de-accumulation vehicle in addition to its traditional role as an accumulation vehicle in creating additional security for employees.

Other benefits to plan sponsors

As a general rule, plans with higher asset levels and higher average account balances often will receive lower per-participant pricing from their service providers. Employers that encourage their participants to use their DC plan as a de-accumulation benefit are able to hold onto these assets, thereby driving better pricing for both their current and former employees. Some employers also seek to maintain a strong relationship with former employees and will allow former employees to use the DC plan to ensure retirement security through their life by education around a “safe” withdrawal rate or by offering a guaranteed product that ensures that participants will not incur any longevity risk with a guaranteed income for life product. Plan sponsors should be aware that there are some additional fiduciary activities when fostering an environment to keep former participants in the plan, in addition to a few practical concerns. For example, a plan that

is near the 100-employee mark may want to keep their plan below 100 (or 120 in transition years) and discourage employees from keeping assets in their plan so that they can continue to be a "small plan 5500 filer" and avoid the cost of a limited-scope audit.

Decision

We believe that employers should think about their DC plan, its effectiveness as a human resource management tool, the cost of the plan relative to the value placed on it, and their relationship to former employees. This thought process will then be the basis for deciding if participants' retirement security can be facilitated through the DC plan offered or if the traditional approach of a rollover to an IRA with an individual financial plan is still the best course of action.

Depending on this initial analysis, the following questions can then lead to a tactical implementation of certain distribution options. A group of industry experts reviewed and answered the following questions that can help sponsors bridge the gap between the desired goals of their DC plan and the practical implications of adding distribution options to the plan.

Questions and Answers

(1) My 401(k) plan currently provides that a terminated participant can either keep their entire account in the plan or take it out in a single lump-sum payment. I've been told that other distribution options can be used. What are some of the other options?

The "all or nothing" approach of permitting only a full withdrawal of amounts from a Section 401(k), 403(b) or Governmental 457 plan might place unnecessary pressure on a retired participant to withdraw the entire account even though only a portion of the account is currently required to deal with immediate financial needs.

The most common distribution option in a 401(k) plan other than a lump-sum distribution is a series of installment payments over a pre-determined period of time. In order to effectuate this kind of withdrawal program, to the plan sponsor must decide how frequently the distributions will be made (monthly, quarterly, etc.) and the maximum time period over which distributions can be made. Generally amounts will continue to be invested pursuant to the participant's investment choices until they are distributed from the plan.

Another common feature is the ability to make periodic withdrawals from the plan. This approach differs from the installment method, in that there is no fixed schedule over which payments will be made. Instead a distribution will be made in such amount and at such time as a participant determines. This provision allows for greater flexibility than the installment method. In our experience, however, in order to simplify administration, a plan will often establish a minimum dollar amount that must be withdrawn and sometimes place a limit on the number of periodic distributions that can be requested within the course of a calendar year.

Another option that can be added to a Section 401(k) plan is an annuity option, which provides for payments over the life of the participant or over the life of the participant and a designated beneficiary. An annuity option typically involves the use of a separate investment product, often referred to as a retirement income product. This can be an attractive option to suit the retirement planning needs of a terminated participant. The existence of a life annuity option may require some additional spousal consent rules. However, these can usually be administered by the entity that offers the retirement income product and should not trigger any significant additional administrative burden for the employer.

(2) Many participants seem to rollover their accounts into an IRA. Why not just let this continue to be the way things go?

Advisors and planners provide a critical service by creating financial plans for participants. The typical financial plan includes a rollover from the DC plan into an IRA or an Individual Retirement Annuity. These services are essential for many individuals who prefer a trusted advisor relationship in the management of their retirement assets.

However, many participants and sponsors do not realize the institutional buying power a retirement plan has with its investment provider and recordkeeper. Large plans can offer investments within their plan with fees as low as .1% to .2% while IRAs can have all-in fees in excess of 1% of the rollover assets. Over many years, this difference in fees can have a dramatic effect on a participant's retirement security. In fact, in May of 2016, Plan Sponsor Journal reports that a fee differential of 1% can have a very significant impact over the long haul:

> *"… Paying just 1% more in fees would cost a Millennial more than $590,000 in sacrificed returns over 40 years of saving. In another scenario, a Millennial with the option of investing in either of two commonly held funds can save nearly $215,000 in fees—and, with compounding, retire nearly $533,000 richer—by choosing the one with fees that are 0.93% lower…"*

The recent DOL regulation "**Definition of the Term "Fiduciary"; Conflict of Interest Rule – Retirement Investment** will have an effect to lower fees in IRAs as the "best interest standard" is applied but will not be reduced to institutional fee levels in larger DC plans.

(3) Do most plans provide for installment payments, periodic payments, or some type of annuity product?

Many plans do allow for one or more of these options, with different plans typically making different combinations of options available to their participants. Plans that don't offer some or all of these options generally can add them to either prototype or individually drafted plan documents.

(4) If I have a prototype plan, are any of these options available to me?

Installment payments, periodic withdrawals and the use of annuity products as either plan investment options or plan distribution options are generally either part of a prototype plan or options that are available to be selected by an employer. Prototype plans can vary by provider, so employers and their advisors should check with their provider and evaluate the prototype plan document to determine what features and options it offers. However, most prototypes can readily add these distribution options; including annuity options, and still enable the sponsor to rely on the prototypes opinion letter.

(5) If I have a prototype plan, what does it cost to add any of these options?

Costs vary. Many providers can make these options available as part of a prototype plan without additional cost, while others may apply a small charge for making changes to the plan document, implementing these options and supporting such distribution options administratively. Defined contribution plan pricing can vary by provider and by plan, so employers and their advisors should check with their provider and evaluate the pricing options and alternatives available to their plans.

(6) If I have a prototype plan, what increases in administrative complexity will I be faced with if I add any of these options?

Minimum distribution requirements. If participants are able distribute only part of their plan balances, then minimum distribution rules will apply to participants who have both attained age 70½ and separated from service. Providers generally have systems and procedures already in place to address minimum distribution requirements.

Qualified Joint and Survivor Annuities (QJSAs). Making an annuity available as a plan distribution option typically will require that a participant's spouse must consent for a plan distribution. Assuming the annuity was not the normal form of distribution, the QJSA annuity administrative requirements would not apply to other forms of distribution (Lump-Sum, Periodic payments, etc.). The QJSA requirements would only apply if a married participant elected a single life annuity; in which case spousal consent would be required. Many providers already have systems and procedures to process these QJSA waivers.

While most providers are already equipped to address these considerations, DC plan administration can vary by provider and by plan, so employers and their advisors should check with their provider and evaluate the options available to their plans.

(7) If I have an individually designed plan, how complicated is it to add any of these options to the plan document?

In order to add an installment payout feature, a periodic withdraw feature, and/or an annuity payment feature to a plan that is individually designed, it will be necessary to have appropriate language drafted and formally adopted by the committee or entity that has amendment authority with respect to the plan. The language to establish any combination of these payout features can be standardized and should not involve any significant expense to the plan or the plan sponsor. Also, in order to offer the annuity option, you should select an appropriate retirement income product. Next, ensure that the designated alternative can be properly administered through the offices of the third party administrator utilized for the plan. In addition to amending the plan, you'll need to modify the distribution election forms used by the plan and to add appropriate language to both the summary plan description and any exit interview documents used by the employer to process people upon termination of employment. Again, the concepts are standardized and it should not be expensive to obtain a working draft of the required language.

(8) If I have an individually designed plan, what additional administrative burdens will I create by adding any of these options?

There will be a need to test the administrative capability of the plan to ensure that it can accommodate periodic distributions, whether in the form of installment payments, periodic withdrawals or annuity payments. Most DC providers can accommodate these payment structures, but the sponsor should confirm that this is the case. Additionally, most annuity payments will be made through a particular product and will not require direct efforts on the part of the plan administrator. The installment payments and the individual withdrawal mechanisms are not difficult to administer with appropriate constraints on the flexibility associated with the withdrawal options.

(9) Why would adding of these options be in the best interest of the plan participants?

As noted above, participants who are able to take advantage of the institutionally priced investments can increase their retirement savings (and thus, their retirement security) through lower fees. Plan sponsors have an inherent interest in providing products and guidance that can help promote retirement readiness among participants.

Organizations thrive when their top employees are engaged and motivated, with the ability to move up into vacated roles, which can only happen when their retirees are able to live comfortably without the risk of hardship or the need to re-enter the workforce due to financial difficulty. Participant and sponsor interests are aligned—and are best met when drawdown strategies are designed to last throughout the participant's retirement years. Additionally, providers are poised to innovate and develop in this area to create "win-win-win" strategies where DC plans are utilized as both

accumulation vehicles as well as de-accumulation vehicles, meeting the needs of current employees, retirees, and plan sponsors alike.

(10) Are there any financial benefits to the Company if any of these options are added to the plan?

Today plan sponsors are examining alternatives for reducing the administrative cost of their Defined Contribution Plan. Many have discovered mutually beneficial option that not only helps reduce their costs, but also provides a better retirement experience for their employees. By simply changing the plan document to allow for installment payments, periodic payments or an annuity option, the sponsor may retain more retirees who are likely to have high account balances (retiree balances are normally 2x's plan average). This can improve plan economics and in turn, pricing for administrative services. Using benchmarking data from a national retirement plan advisory firm, we see the magnitude of this saving. By increasing plan size from $10 to $20 million and the average participant balance from $35,000 to $65,000, it is estimated the record-keeping costs will drop from .32% to .21% of plan assets.

If properly communicated, this can be an important tool in workforce management, helping participants realize that their investments in retirement are institutionally priced and overseen by a fiduciary with whom they have enjoyed a long career.

(11) Will adding any of these options increase my exposure as a fiduciary to the plan?

When selecting any option in a retirement plan, a sponsor must follow and document a prudent process. They must show that any change to the plan benefits the participants and beneficiaries. Having retired employees remain in the plan potentially adds a level of required communication, but we find most record keepers more than capable in communicating with retired participants.

Clearly, making a 401(k) plan more retiree-friendly benefits the participants, thus helping the sponsor meet ERISA's Exclusive Benefit Rule.

Conclusion

Defined contribution plans continue to evolve based on participant needs, plan sponsor objectives and the regulatory environment. As DC balances become their largest assets, most American workers will seek to use those assets in the best way possible to ensure retirement security. Plan sponsors continue to push for elevated levels of retirement readiness to empower their employees to retire on time, which is advantageous for both the organizations and individuals. Finally, the regulatory environment has moved the industry in such a way that DC plans can and should be used to generate not only retirement savings, but also retirement income and in turn, retirement security—which is the ultimate purpose of the private retirement system. As the evolution continues, and as plan sponsors review their plans' objectives and distribution options, they must frame their decisions by asking which drawdown strategies are in the best interests of their plan participants. Plan sponsors who challenge themselves to rethink their retirement plan benefit in this way are in the best position to attract, retain, and manage top-performing teams. For those who rise to the challenge, we believe pursuing better retirement outcomes will result in better business outcomes.

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