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401(k) of the Future – Lifetime Income Solutions

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In May 2013, the U.S. Department of Labor (DOL) issued proposed rules which would alter the way 401(k) participants receive their account balance information in the future. Under the proposed rules, plan administrators would be required to provide all 401(k) plan participants an estimate of their monthly income for life at retirement, based on their projected account balance.

In anticipation of these rules becoming final, and the increased interest in lifetime income products and services that will likely result, this paper revisits an increasingly important subject: how can plan sponsors help participants convert accumulated retirement savings into monthly payments they cannot outlive in retirement?

Five Reasons to Consider Adding Lifetime Income Solutions to Your 401(k) Plan:

1. ***Safety Net Risk*** is the risk of declining pension benefits for all Americans. According to the 2013 Social Security Trustees report, the income replacement rate from Social Security for the typical age-65 worker is due to drop from 41% to 27% by 2033 using today's tax revenues, a decline of 34%.[1]

2. ***Longevity Risk*** is the risk of outliving your assets. When Social Security was created, the average life expectancy was 62. Today it is 79 and it is expected to surpass 87 by 2030.

3. ***Market Risk*** is the risk of a sudden drop in the market value of your retirement assets, or a sudden drop in interest rates, just before you need to begin withdrawing from your savings for retirement.

4. ***Ineffective Financial Management Risk*** is the risk of poor investment decisions or excessive withdrawals in retirement. According to a Russell Investments study, the probability of running out of money for a 65 year old using a 5% withdrawal rate, 2.5% COLA adjustment, and 60%/40% stock to bond allocation is 64.4%.[2]

5. ***Cognitive Risk*** is the risk of the diminishing ability to make decisions with age. Approximately 11% of Americans over age 65 have Alzheimer's.[3] As a result of cognitive risks, retirees must consider how their finances will be managed when they are no longer capable of doing so.

These risks can lead to disappointing outcomes for retirees if not managed properly and are driving the financial services industry to create new products and services that help participants convert lump sums of retirement savings into monthly payments in retirement.

[1]"Social Security's Financial Outlook: The 2013 Update in Perspective." Alicia H. Munnell. Center for Retirement Research at Boston College. June 2013.
[2]Russell Investments. "From buyer beware to buyer aware: Evaluating guaranteed income solutions in DC plans." Jeff Eng and Daniel Gardner. December 2012.
[3]Alzheimer's Association. 2013 Alzheimer's Disease Facts and Figures, Alzheimer's & Dementia, Volume 9, Issue 2.

Your Independent Retirement Plan Investment Advisor

Plan sponsors, looking for an edge in attracting and retaining top talent, are starting to adopt these solutions, albeit at a measured pace. According to an Aon Hewitt study of the large plans for which it serves as a Record-keeper, 28% of 401(k) plans offer at least one product or service which assists participants in converting accumulated balances to a lifetime income in retirement.[4]

Lifetime Income Solutions
Lifetime Income Solutions ("LIS") are products and services designed to convert accumulated assets into a lifetime of income in retirement. Products and services can be purchased in a variety of ways. In a broad sense, these products can be separated into 4 categories:

	In-Plan	Out-of Plan
Guaranteed	Deferred Fixed Annuities Guaranteed Minimum Withdrawal/Income Benefits	Annuity Supermarkets
Non-Guaranteed	Managed Accounts	Managed Payout Funds

An **"In-Plan"** LIS is one that allows Plan participants to accumulate lifetime income while their assets remain in the Plan. An **"Out-of-Plan"** LIS is one that requires a Plan participant take a distribution from their Plan to purchase lifetime income outside the Plan. Therefore, an "Out-of-Plan" LIS is generally only offered to participants upon retirement or termination of employment.

The In-Plan or Out-of-Plan LIS can further be categorized as **Guaranteed** or **Non-Guaranteed**. Guaranteed solutions involve the purchase of insurance which convert accumulated assets into monthly income at retirement. A Non-Guaranteed LIS is managed by a professional investment manager in a manner to allow a systematic withdrawal from account assets.

Examples of In-Plan Solutions

"Guaranteed" options
Most In-Plan Guaranteed LIS are designed to produce a consistent flow of monthly income in retirement that the investor cannot outlive. Generally structured as a balanced portfolio wrapped in an annuity contract, a Guaranteed LIS allows a plan participant to make contributions that build a benefit which is defined as units of income at retirement. Unlike a traditional balanced fund, the retirement benefit (monthly income) achieved ratchets higher annually and cannot go down due to poor market performance or changing interest rates.

1. Advantages: Transfers a participant's Longevity Risk, Market Risk, Management Risk, and Cognitive Risk to an insurance company. While much of the risk is transferred to an insurance company, the investor does not need to annuitize (lose control of) the account. This allows the investor to access the assets and to receive an income stream which can be increased even after the payout phase has begun.

[4]Wall Street Journal, "Help Maximizing Retirement Accounts", Anne Tergesen, June 2, 2013.

2. Disadvantages: May expose fiduciaries and Plan participants to the default risk of a single insurer. May lack portability to other recordkeeping platforms, forcing Plan participants who terminate employment to forgo the accumulated LIS benefit. No guarantee of account value. Income may not fall below initial minimum guarantee but may not be the same each year.

3. Examples of Providers: Prudential IncomeFlex, Great West Secure Foundations, and AllianceBernstein Lifetime Income Solutions.

	Prudential Income Flex Target	Great West Secure Foundations	AllianceBernstein Lifetime Income Solutions
Investment Structure	Target Date or Balanced Separate Account	Target Date Funds or Balance Fund	Custom Target Date Separate Account
Income Base Calculation	Annual Ratchet on Birthday Based on Account Value	Annual Ratchet on Birthday Based on Account Value	Annual Ratchet on Birthday Based on Account Value
Withdrawal Rates as of August, 2013	Based on Income Base and Lock-In Date Age Single Life 4.25% Age 55-64 5.00% Age 65-69 5.75% Age 70+ Joint Life 3.75% Age 55-64 4.50% Age 65-69 5.25% Age 70+	Based on Income Base Single 4.0% Ages 55-64 5.0% Ages 65-69 6.0% Ages 70-79 7.0% Ages 80+ Joint Life Above amounts reduced 50bp based on youngest life	Based on Income Base Varies Based on Credits of Income Accumulated
Income Base Step-Up in Withdrawal Phase	Yes	Yes	Yes
Plan Sponsor Minimum	No	No	$500 million mapped assets
# Insurers	1 - Prudential	1 – Great West	Multiple
S&P Insurance Rating	A+	A	Varies
Insurance Cost	1.0% - 1.5% Charged to Participant	90 basis points charged to participant	1.0% Charged to Participant
Portability	Yes, to Prudential Annuity Only	Yes, to GWRS IRA Only	No
Platform Availability	Prudential, Aon Hewitt, Fidelity, T. Rowe, JP Morgan, American Century, Wells Fargo	Great West	Mercer, Vanguard, Fidelity

Non-Guaranteed Options

An In-Plan Non-Guaranteed LIS is typically offered as a **Managed Account**. A Managed Account is a program in which a participant pays a professional investment manager to actively manage their asset allocation. The service is designed to help participants meet systematic withdrawal needs in retirement. Because the investment manager does not use insurance in a Managed Account, the monthly income stream is not guaranteed, and the participant runs the risk of depleting 100% of his/her account value earlier than expected. The participant is charged an asset management or advice fee in addition to the underlying investment alternative fees.

1. Advantages: Transfers a participant's Management and Cognitive Risk to a professional asset manager. Costs are generally lower than programs that require the purchase of insurance. No annuitization is required which allows the investor maximum flexibility to discontinue the service and retain the balance in his/her account. The service is portable to a variety of IRA providers.

2. Disadvantages: The income is not guaranteed. The fees can be higher than managing the account on your own.

3. Examples of Providers: Financial Engines Income+, Morningstar's Retirement Manager with Income Secure, Guided Choices' Guided Spending

	Financial Engines Income +	Morningstar's Retirement Manager with Income Secure	Guided Choice's Guided Spending
Structure	Mutual Funds	Mutual Funds	Mutual Funds
Income Source	Systematic Withdrawal	Systematic Withdrawal	Systematic Withdrawal
Cost of Living Adjustment	Yes	Yes	Yes
Principal Guarantee	No	No	No
Annuitization	No	No	No
Separation of service requirement	No	No	No
Recordkeeping Portability	No (Able to roll account to IRA)	No	No
Recordkeeping Platform Availability	Fidelity, Vanguard, Aon Hewitt, Mercer, JP Morgan, T. Rowe Price	Great-West, Milliman, PNC, Principal, T. Rowe Price	Schwab, Aon Hewitt, ADP, Paychex

Examples of Out-of-Plan Solutions

Guaranteed

Out-of Plan Guaranteed Solutions are typically insurance contracts purchased by the plan participant upon retirement or termination. This option requires a participant transfer some or all of his/her accumulated 401(k) savings to an insurance company who holds the asset in the participant's name, not the name of their former employer's Plan.

Annuity Supermarket: A third party expert selects high quality insurance companies that agree to provide real time immediate annuity quotes to Plan participants seeking to convert some or all of their retirement savings into an immediate stream of monthly income. The exchange of information and resulting annuity quote is provided via a platform made available on the Plan participant website. If a participant selects a quote, paperwork is sent to the participant to complete a trustee to trustee transfer. Once the paperwork is completed, and submitted to the plan sponsor, the sponsor sends a rollover check to the insurance company which then initiates the monthly payments.

1. Advantages:
    a. Convenience: Quotes from multiple insurance carriers are quickly obtained and easily via a web-based portal linked to the plan sponsors plan.

    b. Fiduciary Protection: Expert selection of insurance providers protects plan fiduciaries from default risk of an insurance company.

    c. Institutional Pricing: Annuities are priced using an institutional platform thereby allowing higher monthly payments than purchasing an annuity through a retail channel.

    d. Fee Transparency: Quotes are in the form of a monthly income payment net of all fees.

2. Disadvantages: Participant loses control of the asset and the potential for growing their income through market appreciation. Because the decision to purchase an immediate annuity is difficult and expensive to reverse, proper education/advice is critical.

3. Example of Providers: Hueler Companies. Hueler partners either directly with plan sponsors or through a recordkeeping service provider such as Vanguard, Wells Fargo, and T. Rowe Price.

<u>Non-Guaranteed Options</u>

Managed Payout Funds are mutual funds that combine a portfolio of stocks, bonds, cash, and alternative investments, generally managed by a single asset manager, and provide a fixed systematic withdrawal plan. There are two withdrawal plans that are most common: first is to drawdown 100% of the fund’s assets by a certain age (i.e. 90 years old), and second is to mimic an endowment by providing a set drawdown each year for life.

1. Advantages: These products offer the advantages of portability, liquidity, transparency of fees, and cost efficiency relative to annuity contracts and individually managed accounts.

2. Disadvantages: Neither a participant’s account balance, or income stream is guaranteed. Investor’s must rely on the performance of a single asset manager. A portion of the distribution is typically considered return of capital.

3. Examples of Providers:

a. Fidelity Advisor Income Replacement Fund Series: This series of mutual funds is designed to generate a consistent payout strategy through a fund's time horizon. This series is issued in two year increments (i.e. 2016, 2018, 2020, 2022, etc.).

b. Vanguard Managed Payout Series: This series contains three funds; Distribution Focus, Distribution & Growth Focus, and Growth Focus funds.

c. PIMCO Real Income 2019 and 2029 Funds.

Fiduciary Oversight Considerations

"Should we offer an In-Plan or Out-of-Plan Solution?"

When ***selecting*** an In-Plan or Out-of-Plan solution, ERISA plan fiduciaries are charged with selecting the service provider in accordance with ERISA's "prudent man rule". ERISA's "prudent man rule" states a plan fiduciary must discharge his duties "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 context of an enterprise of a like character with like aims…"

However, the choice of an In-Plan or Out-of-Plan solution does carry different levels of ongoing fiduciary exposure. When an Out-of-Plan LIS is offered to participants, the burden to prudently select the option at the time of purchase remains. However, once the participant's assets are removed from the plan, the plan fiduciary no longer has a duty to monitor those assets, thus reducing fiduciary risk. When an In-Plan LIS is offered, plan fiduciaries must continue to monitor the service provider, and if necessary, terminate the relationship when prudence dictates.

"Should we offer a Guaranteed or Non-Guaranteed Solution?"

A Guaranteed LIS involves the services of an insurance company. Plan fiduciaries should be aware that the selection of an annuity provider for the purposes of providing pension benefit distributions is a fiduciary decision.[5] The Pension Protection Act of 2006 required the DOL to clarify its restrictive "safest annuity available" language used in Interpretive Bulletin 95-1. This clarification provides plan fiduciaries a safe harbor when selecting an annuity provider as long as the fiduciary[6]:

1. *"Engages in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;*

2. *Appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract;*

3. *Appropriately considers the cost (including fees and commissions) of the annuity contract in relation to the benefits and administration services to be provided under such contract;*

[5] DOL Interpretive Bulletin 95-1
[6] 29 CFR 2550.404a-4(b)

4. *Appropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract; and*

5. *If necessary, consults with an appropriate expert or experts for the purposes of compliance with the provisions of this paragraph."*

It is important to note final regulations do not indicate plan fiduciaries must select the safest choice available as it pertains to the annuity provider's future claims paying ability. Instead, to obtain the safe harbor, the regulations apply a "time of selection" standard. With that said, regulations also indicate a duty to monitor the "…continuing appropriateness of the conclusion…[7]"

While the final regulations do not contain specific guidance on information to be gathered, the original proposed regulations contain what might be considered "best practices". The proposed regulations state *a fiduciary shall consider information pertaining to the following*:[8]

1. The ability of the annuity provider to administer the payments of benefits under the annuity to the participants and beneficiaries;
2. The cost of the annuity contract in relation to the benefits and administrative services to be provided;
3. The annuity provider's experience and financial expertise in providing annuities of the type being selected;
4. The annuity provider's level of capital, surplus, and reserves available to make payments under the annuity contract;
5. The annuity provider's ratings by insurance ratings services in order to consider the provider's ability to make future payments;
6. The structure of the annuity contract and benefit guarantees provided, and the use of separate accounts to underwrite the provider's benefit obligations; and
7. The availability and extent of additional protection through state guaranty associations.

Final regulations call for plan fiduciaries to understand the costs of annuity contracts in relation to benefits received. Unfortunately, this is not easily done. In our opinion, four "costs" must be considered: explicit, hidden, prohibited transaction, and education/advice costs.

Explicit costs can be readily determined through disclosed fees such as account maintenance fees, insurance riders, and asset management fees.

Hidden fees, such as differences in mortality tables and interest rate factors used by insurance carriers, may reduce the monthly income received during retirement. Another hidden fee, the transition fee, occurs due to lack of portability. When a participant terminates employment or retires, and can't roll his/her accumulated benefit to a similar type of LIS at their new employer or IRA, the value of the accumulated benefit may be lost. The transition fee, or lack of portability, is the single largest challenge facing Guaranteed Options in our opinion.

[7]29 CFR 2550.404a-4(c)
[8]72 Fed. Reg. 52024, Sep. 12, 2007

Plan fiduciaries should also be aware of the extent to which a prohibited transaction may exist. Often, insurance carriers have the ability to change the fee of Guaranteed LIS programs from year to year. According to Fred Reish, an ERISA attorney with Drinker Biddle, if an insurance carrier has broad discretion to amend the fee structure of an annuity contract, the insurance company may be deemed a fiduciary to the plan. As a result, it is possible for a prohibited transaction to exist as a plan fiduciary is prohibited from using plan assets to his/her own benefit. If a prohibited transaction exists, plan participants may be due restoration of any losses plus interest and penalties from fiduciaries, which may include the Committee who selected the service provider.[9]

Once the process of selecting the LIS service provider is complete, plan sponsors have a duty to accurately and completely communicate plan benefits to participants. This is the second biggest obstacle to the adoption of an LIS. Based on this discussion of the available solutions, it's clear the structure of an LIS can be very complex. Often, human resource staff members are ill-equipped to communicate the intricacies of an insurance contract or managed account. As a result, part of the selection process should include an analysis of the prudence and cost to hire experts to facilitate the proper communication of the LIS.

Plan sponsors also need to compare states in which the Guaranteed products are licensed to be sold against their own physical locations. Although unlikely, the possibility exists that a plant is located in a state where the insurance carrier has not registered its Lifetime Income Solution product.

Conclusion

While the demand for lifetime income is clearly growing, the LIS marketplace remains very fragmented. As the financial services industry struggles to find the right solution to the risks facing retirees during their de-accumulation phase, most Plan sponsors appear to be waiting for more guidance from the U.S. Department of Labor (DOL).

Much like their guidance in the Pension Protection Act of 2006 solidified the presence of the target retirement date fund as the default investment option in most defined contribution plans, the DOL may be forthcoming with similar guidance regarding LIS.

We encourage all clients to examine their philosophy regarding post-retirement benefit planning, and take the steps they deem necessary to assist participants in planning for life after work.

[9]Planadviser, "ERISA Concerns for Annuity Contracts in DC Plans", Corie Russell, March 07, 2013.