Ins and Outs of Participant-Directed Retirement Plans:
Accumulation and Distribution of Benefits

Presented by: Drinker Biddle

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The Retirement Dilemma

The concern is twofold:

• Will participants have enough money when they retire (benefit adequacy)?

• How will participants withdraw their money, so that they do not exhaust their accounts or IRAs before they die?
How are we doing?

“If we take a late retirement and an early death, we’ll just squeak by.”
Successful Plans

While plan sponsors can use a variety of means to improve benefit adequacy, the most efficient and effective efforts have been “automatic:”

- Enrollment
- Deferral increases
- QDIA investing
Focus on Deferrals

Based on recent research, deferrals are the most important factor in determining the adequacy of retirement benefits.

- Use of consultant
- Automatic increases
- Education for older employees
How can you know?

"The good news is you can retire at 65. The bad news is that it’s 2065."
Deferrals

Gap analysis:

- Projects the results of the participant’s current behavior—in terms of retirement income.
- Proposed DOL regulation on projections.
- Provides reasonable benchmarks for comparing those results to typical needs.
- If the participant is falling short, provides guidance about how to close the “gap.”
Your 401(k) rolled over nicely, sat up briefly, then expired.
Issues for Lifetime Income

The following are the principal issues:

- Longevity risk
- Inflation risk
- Sequence-of-return risk
- Cognitive risk
- Withdrawal rate risk

Longevity Risk

People are living longer:

- If a participant and his spouse are both 65, there is a 50% chance that one will live to age 92, and a 25% chance that one will live to age 97.

- Half of today’s 65-year-old men are expected to live to 85, and half of 65-year-old women are expected to live to 88.

Withdrawal Rate Risk

Table 3. Estimated Probability by CRS That A Retirement Account Will Last for at Least a Specific Number of Years

<table>
<thead>
<tr>
<th>Initial annual drawdown rate</th>
<th>4%</th>
<th>5%</th>
<th>6%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probabilities that money will last a given number of years, excluding the impact of investment fees and taxes</td>
<td></td>
<td></td>
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<tr>
<td>25 years or more</td>
<td>97.7%</td>
<td>87.8%</td>
<td>65.2%</td>
</tr>
<tr>
<td>30 years or more</td>
<td>94.0</td>
<td>77.0</td>
<td>49.5</td>
</tr>
<tr>
<td>35 years or more</td>
<td>89.4</td>
<td>66.9</td>
<td>38.8</td>
</tr>
</tbody>
</table>

Source: CRS Monte Carlo simulation of a portfolio consisting of 35 percent S&P 500 index and 65 percent AAA-rated corporate bonds.

But see “The 4 Percent Rule is Not Safe in a Low-Yield World,” Finke, Pfau and Blanchett.
The Withdrawal Risk

One recent study showed that more than 33% of those interviewed had no idea how much they could safely withdraw and roughly 25% expected to be able to withdraw more than 10% of their retirement savings each year.

Given this failure to understand sustainable withdrawal rates, there is a risk that retirees will exhaust their savings when they are in their late 70s or 80s.

See, Lee Barney, “Americans All Over the Map on Retirement Drawdown Rates,” Money Management Executive (October 13, 2011).
Cognitive Abilities

The benefit of a prearranged distribution methodology:

While old age may bring more experience and wisdom, it also diminishes the quality of decision making.

After age 60, the prevalence of dementia roughly doubles every five years. By the time people reach their 80s, more than half will suffer either dementia or other significant cognitive deficits.

Available Products

There are a number of insurance and investment products in the marketplace that are designed – or at least intended – to provide lifetime income.

- **Insurance**: Traditional annuities
- **Insurance**: Longevity insurance
- **Securities**: Managed payout and retirement income mutual funds
- **Securities**: Managed retirement income accounts
- **Blend**: Guaranteed withdrawal benefits (GWB or GMWB)
In-Plan versus Out-of-Plan Options

An issue in the selection of a lifetime income product is whether to offer the product as:

- An option in the plan (referred to as an “in-plan” solution)
- A distribution option (transition-from-plan)
- Neither an in-plan or a distribution solution (“out-of-plan”)
Retirees Using Annuities

Success rate:

Retirees who have annuitized are more than twice as likely to have saved through an annuity in a DC plan while working, compared with retirees who have not annuitized.

Retail Cost versus Institutional Cost

Cost:

Retail annuities can be . . . expensive . . . However, this can be mitigated in institutionally priced annuity programs.

Guaranteed Withdrawal Benefits

In a GWB product, a participant invests in an investment that includes the GWB guarantee. At retirement, the participant begins to take withdrawals . . . (either in the plan or . . . an IRA) at a specified rate (depending on the retiree’s age and whether the guarantee also covers his spouse) based on the participant’s “income base.”

If his account runs out, the insurance company continues to make payments at the same rate.
Guaranteed Withdrawal Benefits

The income base grows with additions to the account or with investment earnings, but does not go down unless the participant withdraws excess amounts. In exchange for these guarantees, the participant pays a premium each year.
GWB Investment Characteristics

The lifetime Guaranteed Minimum Withdrawal Benefit (GMWB) acts as a form of portfolio insurance protecting the investor from downside risk. Conceptually, this is similar to a put option that provides downside protection to a traditional portfolio. Options change the characteristics of the expected return distribution.

Fiduciary Considerations

However, there is no obligation under ERISA for 401(k) plans to provide investments, products or services for retirement income.

If offered, though, the products, investments or services must be prudently selected and monitored.

- White paper on prudent process for selection of insurance provider (being written for Lincoln Financial).
Fiduciary Issues for Insured Products

- Portability
  - Distribution portability
  - Platform portability

- Status as QDIA

- Costs

- Selection of insurer
The Portability Issues

A concern about retirement income products is the “portability issue.”

The issue is, what happens if there is a change in circumstances affecting the participant or the plan (e.g., participant’s termination of employment or a decision by the plan sponsor to move the plan to another provider).
The Portability Issues

While the portability issues for participant distributions can be solved through IRAs maintained by GWB providers, the issues for changes of recordkeepers are more complex.

However, the 401(k) and 403(b) industries have developed solutions to that problem.
ERISA’s Prudent Process

The DOL’s regulatory “safe harbor” is available to fiduciaries that engage in the following steps, in addition to considerations of cost:

- Engage in an **objective, thorough and analytical search** for the purpose of identifying and selecting an insurance company.

- **Consider** information to assess the ability of the insurance company to make future guaranteed payments.

*continued . . .*
ERISA’s Prudent Process

• Appropriately conclude that, at the time of the selection, the insurance company is financially able to make future payments under the annuity contract.

• If necessary, consult with a knowledgeable consultant.
Fiduciary Checklist for Insured Benefits

Key factors to consider:

- Strength and stability
- State insurance regulation
- State guarantee associations
Strength and Stability

Key measures are:

- The insurance company’s RBC ratio
- Quality of financial strength ratings across the agencies
- Consistency of ratings over the years
- Experience in providing annuity guarantees
- State insurance regulation
- State guarantee associations
Demographic Considerations for Plans to Select GWBs

- DC retirement plan sponsors who are comfortable with innovative ideas as part of their culture
- Sponsors with older employees who want orderly transition of workforce and long-term focus for younger employees and recruits
- Sponsors who perceive responsibility for their employees
- Sponsors who discontinued DB plans and seek analogous guarantees
Demographic Considerations Where Plans Might Not Select GWBs

- 401(k) and 403(b) are a supplement to generous defined benefit plans
- Companies that, as a matter of culture, tend to be late to adopt to change
- Sponsors that prefer the status quo, rollover, individual responsibility for retirement
- Sponsors with young, high-turnover workforce
Efficiency of Retirement Money

It is significantly more cost effective for a person to insure longevity risk through risk pooling (whether through purchasing an annuity or other lifetime income guarantee, or electing a lifetime income option in a pension plan) than to bear that risk alone.

In contrast, depending on the method used to “self-insure,” 50 percent to 75 percent more money would need to be set aside than if an individual participated in a risk-pooling arrangement.

Practical Considerations

We found that during the down market from 1Q/08–2Q/09, plan participants invested in in-plan guaranteed retirement income were 2.5 times more likely to stay invested in equities than participants without an in-plan guaranteed retirement income option.

“Better Participant Outcomes Through In-Plan Guaranteed Retirement Income,” Christine C. Marcks and John J. Kalarides, Prudential. Proprietary research by Lincoln Financial also found that participants with downside risk protection were two to three times more likely to stay invested.
Conclusion of White Paper

The selection of an annuity provider is not inherently different from any other decision that must be made by plan fiduciaries.

- Second white paper is being developed, which describes a step-by-step process for fiduciary selection of a provider of in-plan guarantees and review the Lincoln GWB in that context.
Thank You

For additional information
Contact your Lincoln representative or call (855) 533-2170