The Overlooked Income Vehicle, III

By Kerry Pechter *Thu, Jul 2, 2015*

Systematic withdrawals from DC plans are one of the simplest and cheapest ways to generate income from tax-deferred savings in retirement. Rollovers get the headlines, but more people advocate SWPs than you might have thought.

The rollover IRA has already surpassed the 401(k) plan as the platform from which U.S. retirees will draw most of their private retirement income. But some entities—Department of Labor officials, some plan sponsors and plan providers—would like to see that trend slow down or even reverse.

They'd like more Americans to eschew rollovers and, instead, keep their savings in their 401(k) plans, and use a systematic withdrawal plan or SWP—monthly electronic transfers from plan to bank account—to provide regular income over a specific portion of their retirement or for life.

The pro-SWPs crowd is smaller and quieter than the horde of rollover advocates, for obvious reasons. Huge profits await advisors, asset managers and insurers who capture some of the $7.2 trillion rollover treasure. SWPs don't offer anybody much in the way of spoils, unless you count the savings that retirees might realize from having access to institutionally priced products and services.

Still, SWPs advocates exist, mainly among plan sponsors who see them as a potential way to fulfill their fiduciary duties and maintain economies of scale in their plans, and among plan providers that have financial incentives to retain plan assets.

SWPs cheerleaders

A SWPs program, for instance, was among the four measures for improving DC plan design, along with making roll-ins to 401(k)s easier, tightening loan restrictions, and establishing auto-enrollment, that *PlanSponsor* magazine recommended in its annual DC plan review earlier this year.

The magazine quoted one plan advisor as saying that more plan sponsors are coming to regard establishing a robust SWPs program as "a sort of compromise" between offering their retired participants an in-plan annuity and risking a breach of fiduciary duty by not offering them any income option at all.

The Institutional Retirement Income Council (IRIC), a fledgling trade group consisting of retirement plan providers, has recommended SWPs to plan sponsors. In a May 2015 white paper, IRIC listed SWPs as one of three withdrawal solutions that have the "potential to increase retirees' incomes by five to 20% or more." Immediate annuities and living benefit riders on target date funds were the other two.

That whitepaper, written by actuary Steve Vernon of the Stanford Center for Longevity, cited a 2013 report, "The Next Evolution in Retirement Plan Design," prepared by the Society of Actuaries, the SCL, Wade Pfau of The American College and ERISA attorney Fred Reish.

That report included systematic withdrawals as one of several "Characteristics of a Successful Retirement Program." SoA like SWPs because "the process required to change providers prospectively with remaining assets is usually straightforward" and "in-plan solutions increase assets under management, helping to reduce unit costs for administration." On the other hand, SoA was wary of SWPs because "retirees may think that the income is guaranteed for life when it really isn't. Not only might they deplete their savings, but they may be surprised to learn that it can happen."

What would your SWPs look like?

A plan sponsor who wanted to introduce a SWPs program would have to decide what kind of installment distribution method it wanted to offer. There are lots of ways to structure a SWPs. The function can be outsourced to a managed account provider like Financial Engines. There might be a menu of elective SWPs-based options, perhaps including a default program for those who don't choose.

Jack Towarnicky, an Ohio-based plan consultant, suggested a non-guaranteed SWPs structure that would nonetheless try to provide lifetime income. "I'd like to see a plan sponsor add a payout based on life expectancy, as a standard option for people who have reached age 55 [and have been terminated] or who have reached age 59½ [when then 10% penalty expires]. It would work just like the MRD after age 70½," he said.

"If we're really concerned about longevity risk, then we should change Section 401(a)(9), the MRD rules, so that you're not required to take out more than 5% in any year," Towarnicky added. "The required withdrawal reaches 5% at about age 78. The other possibility is to couple the systematic withdrawal with a deferred income annuity."

In Britain, such a program has just been proposed. Last weekend, Britain's new publicly-

sponsored defined contribution plan, called NEST, issued a “blueprint” for a default decumulation plan that its auto-enrolled participants could use when they reach retirement.

According to this three-bucket blueprint: At retirement, 10% of a participant’s tax-deferred savings would go into a cash fund and 90% would go into a centralized, risk-managed fund. The larger fund would generate an inflation-adjusted monthly income, proportionate to the assets invested, until age 85. At age 85, if the participant was living, he or she would begin receiving payments from a deferred income annuity that will have been purchased at age 75 with monies collected gradually from the income-generating fund between age 65 and 75.

Here in the U.S., Vanguard offers its participants two types of SWPs. In June, the company published an article on its website (“Helping retirees stay on the upside of drawdowns”) that described its Guided Installments program. Under this free, do-it-yourself variation of SWPs, retired participants can use web-based calculators to determine how much they need to withdraw from the 401(k) accounts as well as how much they can afford to withdraw and still maintain an 85% probability that their money will last until age 95. The service also includes rebalancing reminders and automatic adjustments for RMDs and inflation.

For a fee, Vanguard participants also have the option of putting their savings into managed accounts run by Financial Engines, for accumulation and distribution. In the distribution, a Financial Engines program called Income+ (Income Plus) begins producing a payout rate designed to last until the retirees’ early 90s. For retirees who want insurance against longevity risk, Income+ shifts enough money into bonds during retirement to pay for an optional deferred income annuity, to be purchased outside the plan.

Getting from here to there

While there’s no shortage of SWPs-based solutions, there’s no clear path from the status quo to a world where a worker would be auto-enrolled into a target date fund in a 401(k) plan, have his or her deferrals auto-escalated, and then defaulted into a SWPs program with built-in or optional longevity insurance—thus bringing defined benefit-type security into the defined contribution world.

The only ones who could lead such a trend would be plan sponsors or participants. But no two plan sponsors are alike in their sense of the scope of their fiduciary responsibility, their ability or willingness to finance the participant education that a SWPs program would require, or their willingness to accept the long-term liabilities that choosing vendors for SWPs might entail. They might be reluctant to offer SWPs for the same reasons that they

abandoned DB plans for DC plans.

The future of SWPs might depend in part on the Department of Labor's conflict-of-interest proposal, and whether or not it passes in its current form. If it does, plan sponsors and their advisors might feel a greater fiduciary obligation to at least include a low-cost SWPs program among the distribution options they offer retiring participants.

On the other hand, if the proposal's language is softened to accommodate the status quo, it's hard to see where a champion for SWPs might emerge from, or why the torrent of savings from ERISA-regulated 401(k)s to more permissive rollover IRAs wouldn't continue unabated.

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