The Overlooked Income Vehicle, II

By Kerry Pechter *Wed, Jun 24, 2015*

If more 401(k) plans offered systematic withdrawals, more money might stay in 401(k)s, and the DOL might not need to attempt the difficult and divisive task of policing rollover IRAs.

Americans have transferred more than $7 trillion from employer-based retirement plans to rollover IRAs, and the private financial sector—asset managers, insurers, broker-dealers—is competing mightily to capture chunks of that tax-deferred treasure and show retirees how to invest it, spend it, bequeath it and/or minimize taxes on it.

So it's easy to forget that millions of participants in 401(k) plans also have the option—at a much lower cost, potentially—to keep some or all their qualified savings in their 401(k) accounts after they retire, and draw down a regular income from those accounts through a so-called systematic withdrawal plan, or SWP.

SWPs aren't a tool that many Americans use, or that all plans offer, even though big plan providers such as Vanguard and Fidelity make them available. Last week, *RIJ* showed that one reason for the low uptake is that only 55% of plan sponsors (and only about two-thirds of large plan sponsors) offer SWPs. This week, we'll look at some of the causes of the shortfall in availability.

Given the current fight over the Department of Labor's proposal to reform the treatment of qualified money in rollover IRAs, the low usage of SWPs seems like a timely issue. If 401(k) plans became more convenient as an income vehicle for retired participants—with universal access to SWPs, living benefits or the new QLACs (Qualified Longevity Annuity Contracts)—the consequences could be significant. More money might stay in 401(k)s, and the DOL might not need to attempt the difficult and divisive task of policing rollover IRAs.

'Tethered' to ex-employees

There's one obvious reason for the low adoption rate of SWPs by plan sponsors. A lot of sponsors, evidently, don't offer SWPs because they don't want to maintain 10-, 20- or even 30-year financial relationships with former employees, many of whom may have worked at the company for only a few years and may have departed on less than amicable terms.

"I think the issue is that when you leave an employer, both you—and your employer—are ready to 'move on,' " a retirement plan industry veteran told *RIJ*. "Systematic withdrawals keep you tethered. And do you want to *pay* for the privilege of doing something you're not inclined to do anyway?

Only a minority of employers, frequently described as "paternalistic," claim to worry sincerely about the future well-being of their retirees, especially the long-tenured ones. Companies that once offered defined benefit pensions, and where the tradition of lifelong ties to ex-workers is instilled, are most likely to fit that description.

Smaller, or more risk-averse employers are more likely to worry about potential fiduciary responsibility for people who don't work for them anymore, or about the potential cost of providing SWPs. Some sponsors continue to fret about potential legal problems even though experts say that, under ERISA, employers are not responsible for the results of participants' independent investment decisions. As for expense, the cost of regular electronic transfers from the plan to a retiree's bank is said to be minimal.

Although all 401(k) plan sponsors must start sending required minimum distribution checks to retired participants who are age 70½ or older, most plans actively discourage distributions before that age by not allowing "ad hoc" partial withdrawals, according to Vanguard. Companies that don't allow ad hoc withdrawals are unlikely even to consider SWPs.

"Ninety percent of Vanguard DC plans require terminated participants to take a distribution of their entire account balance if an ad hoc partial distribution is desired," according to a Vanguard whitepaper. [["Retirement distribution decisions among DC participants. "For example, if a terminated participant has $100,000 in savings, and wishes to make a one-time withdrawal of $100, he or she must withdraw all savings from the plan, For example, by rolling over the entire $100,000 to an IRA and withdrawing the $100 from the IRA, or by executing an IRA rollover of $99,900 and taking a $100 cash distribution." This section seems to be disjointed and needs to be reworked.]]

According to *How America Saves 2015*, Vanguard's survey of its plans, 13% of plans, with 30% of participants, offer ad hoc distributions.

John Blossom, a registered plan fiduciary at the Alliance Benefit Group of Illinois, noted that plan sponsors do worry about the expense of ad hoc withdrawals, perhaps unnecessarily. "Most plans do not think that it would be a helpful option to allow partial withdrawals and most third-party administrators charge a substantial fee—like $90—to process a distribution. It doesn't occur to them that partial withdrawals might be less expensive after the first one.

“There is a cost, however, involved with tax withholding, along with the cost of a check or ACH. Also, many plans are charged a per capita fee for accounts with balances, so employers, generally, have a disincentive to keep them in the plan after separation from service. Another disincentive applies to financial institutions and ‘advisors’ who profit by rolling account balances into an IRA. They want to get it all. The new [proposed DOL] regulations may reduce this playground for ‘advisors’ by reducing the push for an all-or-nothing withdrawal,” he noted.

Liability concerns

“The willingness to offer SWPs varies by sponsor and retirement committee, depending on whether they feel it’s needed or not,” said Douglas Conkel, a senior benefits consultant who specializes in defined contribution at Milliman, the global actuarial firm. “A lot are still in the mindset that former employers (employees??) can just use an IRA or some other outside vehicle, and that they don’t need to mess with it. But we’re seeing some renewed interest in SWPs from plan sponsors. The interest is typically generated by former employees who ask for them. The plan sponsors are starting to listen,” he added.

“There’s really no downside to SWPs. It’s a bit of a reversal of current practices, so any transition will be slow. It will start among companies that already feel obligated to take care of former employees. The employer might say, ‘Our retirees gave us 10 or 15 or 20 years, so let’s go ahead and offer this.’ There’s not as much liability these days with keeping the assets in the plan. The 404(c) rules limit the liability [for adverse investment outcomes in participant-directed accounts] for fiduciaries.”

One observer noted that plan sponsors do worry about legal liability on SWPs. “I’m surprised that the number of sponsors offering any type of SWP is as high as 50%,” said Robb Smith, an independent plan fiduciary based in Orlando. “SWP in the DC market is still a relatively new concept. There’s a lack of understanding and/or conviction among plan advisors regarding SWPs, and lack of clear direction from regulators and strong safe harbor protection for workplace fiduciaries.

“Sponsors are still hesitant about the types of SWP options that are acceptable, about participant pushback and heightened risk exposure. Most plan sponsors are still spooked by DOL fee disclosure and rhetoric about high fees on their core offerings, without the additional headache of monitoring SWPs. But the number one reason is a lack of clear training for workplace fiduciaries. They're left in the dark on at least two-thirds of their fiduciary duties."

More than one observer told *RIJ* that 401(k)s lack SWPs because the idea of using DC plans for income is relatively new. "Many DC plans were built off templates and were designed when defined benefit plans were still in place and no one anticipated that 401(k)s would be anything more than a supplemental source of retirement income," said a member of the Defined Contribution Institutional Investment Association, who works for a major plan provider.

Some plans are old enough that no one at a company may know whether the plan document includes a provision for SWPs or not. "A lot of plan sponsors were not there when the plan document was written, and they haven't necessarily familiarized themselves with all of the plan rules," the DCIIA member added.

Another plan consultant who asked not to be identified told *RIJ* that many small plans are sold by registered reps who do not put great care into plan design and who may not want to take on the responsibility for providing the advice and support that an SWP program would inevitably entail.

"First, it requires work on behalf of the providers and professional advice which, unfortunately, a good many plans cannot currently get because they bought a product from a product pusher," he said.

"Second, there are too many plans where the compensation for the recordkeeper or third-party administrator and broker are based on assets. If assets leave, compensation will go down. Third, designing the withdrawal program for the client would require 'advising' and 'managing' that process for the client, and too many brokers are woefully unqualified to do that."

The cost of education

SWPs might be more common if participants clamored for them, but they aren't. "There's no significant participant demand to justify the investment to build this functionality within the plan," Jack Towarnicky, a Columbus, Ohio employee benefits attorney who has worked at Willis North America and at Nationwide, commented in a LinkedIn discussion initiated by *RIJ*. "And until recently, there's been no significant initiatives or innovative designs by product or service providers.

“There’s been a shortage of service provider effort, especially among third-party administrators, in ‘adoption of 21st century banking functionality’ such as ACH (Automated Clearing House), electronic billing and payments and asset transfers into plans, that would facilitate and encourage low-cost, adjustable installment payout features,” he said.

The biggest cost associated with SWPs might be the participant education required to do it right. A SWPs candidate would need to decide not only how much to withdraw—what amount or percentage—but also which funds to draw money from in what proportions and in what order. Retirees might need customized advice in order to get it right, especially if they don’t have the option to alter their chosen SWP program.

“Once you give people choice, you have a tremendous education component,” Towarnicky said. Meghan Murphy, a director at Fidelity, told *RIJ* that this challenge arises even if the clients merely want ad hoc distributions. “If people say, ‘Can I get payments every so often?’ then big decisions come into play, and that can be overwhelming for them.”

Next week: Experts contemplate the future of SWPs.