TESTIMONY BEFORE THE ERISA ADVISORY COUNCIL WORKING GROUP ON SPEND DOWN OF DEFINED CONTRIBUTION ASSETS AT RETIREMENT

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The Profit Sharing/401k Council of America (PSCA) is a non-profit national association of employers who sponsor defined contribution retirement plans for their workers. For over sixty years, PSCA has identified and shared best practices with its members, represented their interests in Washington, and provided analysis and reportage on the latest regulatory changes. PSCA members range in size from very small independent businesses to firms with hundreds of thousands of employees. Our members believe that profit sharing, 401(k), and related savings and incentive programs strengthen the free-enterprise system, empower and motivate the workforce, improve domestic and international competitiveness, and provide a vital source of retirement income.

In a defined contribution plan participant contributions, company contributions and returns on those contributions accumulate over time in an account owned by the participant. In other words a defined contribution plan builds personal wealth for the participant. Recognizing that IRAs are defined contribution plans, every working American has the opportunity to build and preserve retirement wealth on a tax advantaged basis and a substantial number are doing so. The amount of retirement wealth in tax-advantaged defined contribution plans, including IRAs, has grown from $2.5 trillion in 1994 to $9.4 trillion at the end of 2007. A 2008 McKinsey & Co. study, “Redefining Defined Contribution" projects that by the end of 2015 employer-sponsored defined contribution plans will hold between $7.5 trillion and $8.5 trillion dollars, while at the same time generating approximately $3 trillion in rollovers into IRAs. As a result, the total retirement wealth in these programs by the end of 2015 will be between $15 trillion and $17 trillion. In contrast, the Social Security trust fund has approximately $2 trillion.

The enormity of these sums has generated interest in how the owners of this wealth will manage and utilize it after they retire. Policymakers, employers and financial service providers are now engaged in studies and discussions about what will happen and what should happen. At this time I urge that there be no recommendations for legislative or regulatory change. Providers, recognizing the opportunity that will come with helping retiring plan participants manage their money, are aggressively engaged in the development of new ideas, new processes and new tools to help retiring baby boomers. Nothing should be done that would impair this activity. Also, we just do not know enough. At this point there are things we know but questions yet to be answered. I compliment the Council for addressing this issue, and believe your efforts will help us all better understand the issues involved and move us toward answers to the questions.

WHAT WE KNOW

Social Security. Social Security pays an annuity adjusted for inflation to nearly every American worker. It replaces a larger portion of pre-retirement income at lower income levels. Married couples can each elect to receive their own benefit or 150 percent of the higher benefit. Social Security provides a 100 percent survivors benefit. In two-earner families, the remaining spouse can switch from their own benefit to the spouses benefit if it is higher. It is unrealistic to consider what will happen, and what should happen, to defined contribution wealth in retirement without including the benefits provided by Social Security.

Minimum Required Distributions (MRDs). Beginning with the calendar year after the year people turn 70½, retirees are generally required to withdraw a minimum amount of money from their tax-advantaged retirement accounts each year. This amount is called a minimum required distribution, or MRD. Generally, someone's MRD is determined by dividing the adjusted market value of their tax-deferred retirement account as of December 31 of the prior year by an applicable life expectancy factor taken from the Uniform Lifetime Table provided by the IRS. In effect, the government requires that retirees with a defined contribution accumulation begin converting their retirement assets into a fixed stream of payments once they have reached a certain age. As with Social Security benefits the impact of the MRD rules should be part of any discussion of the management of defined contribution retirement wealth.

Most Current Retirees Rollover to IRAs. A number of studies show that the amount rolled over into traditional IRAs from defined contribution plans continues to increase. (Traditional IRAs are the most common type of IRA owned, followed by Roth IRAs and employer-sponsored IRAs.) Department of Labor Form 5500 data for private sector plans demonstrates this as well. From 1989 through 2005 retiring defined contribution plan participants have been rolling over their balances into an IRA at a far greater rate than those who terminate their employment prior to retirement. During a period when the number of active defined contribution plans participants has nearly doubled, the number of retired participants who have left their assets in their plan is up only 56 percent, from 436,000 to 672,000, while the number of terminated vested participants choosing to do so is up 609 percent, from 2,167,000 to 12,452,000.

Since most defined contribution wealth after retirement is being maintained in an IRA, what current retirees are doing with their IRA assets should be part of the discussion about the distribution phase of the defined contribution plan process.

Current Retirees Are Delaying Distribution From Their IRAs. Most current retirees with defined contribution assets are not consuming these tax deferred assets until they must by law. As noted above, most defined contribution assets are maintained in IRAs once a person has retired. According to “The Role of IRAs in US households’ Saving for Retirement" a Research Fundamentals paper published by the Investment Company Institute (ICI) in January of 2008, only 19% of households aged 59 to 69 took a withdrawal from their traditional IRA. Withdrawals mainly occur after age 70. Typically withdrawals from traditional IRAs are taken to fulfill the MRD requirement. “Six out of 10 households owning traditional IRAs making withdrawals in tax year 2006 did so to satisfy this requirement.”

The 2008 ICI report also referred to a 2007 survey of IRA owners that indicated that 70% were either not very likely or not at all likely to take money from their IRAs prior to age 70 1/2. 80% reported they have a strategy for managing income and assets in their retirement. “With respect to the planned role for their traditional IRA assets in retirement, seven out of 10 traditional IRA owners with a strategy plan to preserve their IRA assets as long as possible.” Finally, 68% of these IRA owners reported using a professional financial advisor to help develop their plan.

Many are concerned that retirees relying on defined contribution plan accumulations will outlive their resources. Current retirees maintaining their defined contribution assets in an IRA appear to understand that risk and are choosing to delay taking distributions for as long as possible as a way to ensure their money lasts as long as they do.

Taxes matter. Distributions from tax deferred savings programs are taxed when they are constructively received by participants. Further, taxable income from tax-deferred savings programs is included in the determination of whether or not a person's Social Security benefits are subject to taxation. Someone will have to pay federal taxes on their benefits if they file a federal tax return as an "individual" and their total income is more than $25,000. If they file a joint return, they will have to pay taxes if they and their spouse have a total income that is more than $32,000.

Limiting tax liability with good planning can significantly impact a person's after tax retirement income. For example, in some cases, it might be beneficial to accelerate contributions from an IRA and delay receipt of Social Security benefits. Someone using this strategy could limit the amount of their MRDs and reduce the amount of their taxable income so that their Social Security benefits are not taxable. They would also substantially enhance the amount they receive annually from Social Security. Any discussion of the utilization of retirement income from defined contribution plans should include an evaluation of the impact of taxation.

Innovation. Major providers of services to defined contribution plans and IRAs are developing new products and tools to assist retirees with the management of their defined contribution wealth. They have made these new tools available on their websites and some of them undoubtedly have described them in the testimony that precedes mine. The financial planning community is encouraging financial advisors to get special training in retirement planning and has developed special designations for those who do. Annuity providers are developing old age annuities that pay benefits only if an individual attains a certain age. This allows a person to insure against outliving their money but does not require them to purchase an annuity initially at retirement.

As an example of this innovation I highlight Income Solutions® developed by Kelli Hueler of Hueler Associates. Using an online purchasing program utilizing an IRA accessed from the plan sponsor's website, Income Solutions® provides a retiring participant the opportunity to purchase an annuity under the most favorable of circumstances. Offering this program to retiring participant provides them access to:

- Group and even institutional pricing
- Meaningful competition by annuity providers
- A standardized quote request
- A simplified quote response format
- Basic tools and Education
- Provider Choice
- Partial annuitization
- Flexibility
- Ability to Diversify
- Integration with the other services offered to participants.

We should carefully study the new ideas and solutions being developed in the marketplace and we should not do anything that would inhibit what can only be described as a burst of innovative thinking.

QUESTIONS TO BE ANSWERED

What will be the role of the employer? Historically, defined contribution plan sponsors have assumed that retirees would take their plan accumulations as a lump sum and roll it over into an IRA. In fact, many plans took advantage of the law that permits a forced distribution at age 65. This is changing. According to PSCA's 50th Annual Survey of Profit Sharing and 401(k) Plans 73.6% of plans permit participants to retain their balance in the plan after they retire if it's more than $5,000. This result is size correlated. 80.8% of the largest companies but only 61.3% of the smallest companies provide for this. In conversations with PSCA members it is clear that smaller employers feel incapable of assisting their participants after they retire with the management of their plan assets, even those who will let their retirees keep their defined contribution assets in the plan after they retire.

Earlier this year 213 PSCA members responded to a survey specifically on this subject. 5% of respondents actively encourage their retiring participants to leave their accumulation in the plan. 11% actively encourage them to withdraw the assets or force a distribution. 84% were ambivalent. Asked whether or not they were assisting participants in the selection of an IRA provider, 35% said they were. They were also asked "Which of the following education/guidance/information does your company provide to retiring participants?"

- 11% said none, except notices required by law.
- 34% provided access to an employer selected financial advisor.
- 78% provided educational materials explaining the options available under the plan.
- 68% had a retirement income calculator available online for participants.
- 31% offered seminars regarding retirement assets and income planning.

Some employers are going to take an active role in helping their retiring participants manage their money in retirement. For retirees from large companies leaving their money in the plan will be an especially attractive option as they will benefit from high level fiduciary oversight and institutional pricing. However, the number of employers who offer post retirement assistance and what that assistance will be is yet to be determined.

What is the retirement spending curve? As a society we are still learning what it costs to be retired. Is it an equal amount each month indexed for inflation? Does it follow a U-shaped curve with larger expense during the period immediately following retirement when a retiree has good health and energy, followed by a period when expenses gradually decline along with the individual's health and energy level, followed by a final stage when expenses increase as the individual's health declines to the point where an individual needs significant care by others? How important is it to be financially prepared for unexpected financial events? Can we rely on studies of current retirees, whose working careers were primarily during a period when the single wage earner model prevailed, to project the retirement experience of baby boomers where families had dual incomes more often than not? I believe we have a lot more work to do before we have the answers to these questions.

How much do retirees need? Since 1988, Georgia State University, in conjunction with Aon Consulting, has continued to update their research on benchmarking retirement income needs. Their most recent report was published in 2004 and I believe the newest update will be published shortly. Others have done their own studies. In the past it was generally agreed that between 70% and 80% of pre-retirement income in retirement would provide the same amount of net after-tax spendable income for retirees. However, future retirees may have different needs than those currently retired. For example they will probably live longer. Also, their primary healthcare provider will be Medicare so how much will they need to supplement their Medicare coverage? Will future retirees work in retirement? How much and for how long? How much does individual circumstance matter? Is there even sufficient uniformity for a generic target? We may be able to come up with generic targets for younger workers, but will those generic targets, or any targets, be appropriate for those within 10 years of retirement?

What about annuitization? The evidence about whether or not those taking lump sum distributions from their retirement plan are purchasing annuities is inconclusive. It is true that in the approximately 20% of defined contribution plans that offer annuities nearly all retirees initially choose a lump sum, rolling it over into an IRA or leaving it in the plan. However, some or all of an IRA balance may subsequently be used to purchase an annuity. When it makes sense to purchase an annuity retirees may be doing so. For example, I know a person who annuitized his tax deferred accumulations when he was 80. It would be interesting to know the percentage of IRA assets invested in annuities and when that annuitization occurred. What happens when a person is required to take an MRD? To my knowledge, no study has followed retirees who have taken lump sum distributions to see how they have managed their money over the remaining decades of their lives.

What about the differences between men and women? It may be politically incorrect, but the retirement needs for men and women are usually very different and it's time to face those differences in our public policy discussions. We all know that women live longer than men and that the ratio of very old women to very old man is approximately nine to one. We know that men are typically three years older than the women they marry, which virtually assures a prolonged widowhood for women who marry. Studies I have seen indicate that men remain physically competent until within a few months of their passing, while women experience a prolonged period of decline during which they may need extensive support. This is borne out by the results of recent survey by Country Financial Security that found out that the number one financial concern of men in retirement is not having enough money to do what they wanted to do and the number one concern of women is running out of money.

Past solutions have been predicated on getting men to act contrary to their best interest. We must break away from this approach which does not work for those with defined contribution assets. For example, if an annuity is offered through a plan, unisex tables must be used. Annuities sold in the retail market can use gender-based pricing. If a man wants to buy an annuity it may be that he should roll his distribution into an IRA first to get the most favorable pricing. Also, few men need nursing home care beyond what is provided by Medicare and yet many urge that everyone buy long-term care insurance. Men acting in their own best interest do not use their own money to buy long-term care insurance.

In conclusion, in the decades ahead trillions of dollars from employer defined contribution plans, and the IRAs funded by employer defined contribution plan distributions, will be available to support the retirement of today’s workers. These amounts should in no way be equated with defined benefit plan distributions. Defined contribution plan assets are owned by individuals and greatly valued by them. As a result they will be looking for solutions that will help them maximize the utility of these assets taking into account their personal situation. They will analyze all of the possibilities, often with the help of fee for service advisors, as they make decisions about how these assets are to be managed. As a result, service providers will be forced to compete aggressively with innovative services and products tailored to the individual needs of retirees if they want a role in managing these assets.

Also, the financial support these assets will provide to retirees will be supplemented by the substantial indexed annuity provided by Social Security Social Security and retirees will be forced to deal with the minimum distribution rules. Tax considerations will be part of a defined contribution plan beneficiary's planning process.

Managing wealth is different than living on a stream of income determined by someone else. To paraphrase, "we are boldly going where only the wealthy had gone before." This is new territory and will require new thinking and new approaches. We should be cautious about reflexing into generic one-size-fits-all solutions. We still have a lot of learning and thinking to do.

I appreciate the opportunity the Council has given me a comment on this incredibly important issue.

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