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ADMINISTRATION

Retirement Income Projections

The comment period for the DOL's ANPRM on providing retirement income projections to participants ended in July 2013, but the discussion is just beginning.

BY GENELLE BRAKEFIELD

"It's tough to make predictions, especially about the future," Yogi Berra once noted. Even tougher might be shifting participants' perceptions from the 401(k) as a piggy bank to a savings vehicle that can secure their retirement future.

The Department of Labor is trying to do just that by illustrating the 401(k) account balance in terms of a lifetime income stream. On April 17, 2013, the DOL's Employee Benefits Security Administration issued an Advanced Notice of Proposed Rulemaking (ANPRM) regarding the intention to require defined contribution plans to provide retirement income projections to participants on a periodic basis. The 46-page ANPRM discusses the DOL's reasoning, findings from their 2010 RFI and subsequent joint hearing, and proposed methodology for providing such information to participants.

The comment period for the ANPRM ended in July 2013, but the discussion is just beginning. Industry experts will argue the merits of requiring such projections, what form they should take, whether estimates currently provided to participants will be changed in favor of a safe harbor, whether participant behavior will change, and how industry practices should evolve in light of a mandate.

FIG. 1: SAFE HARBOR ASSUMPTIONS

			Lifetime Income/Month with Joint & Survivor Annuity	
		Lifetime Income/Month for Participant with No Survivor Benefit	Participant	Spouse with 50% continuation
Current Account Balance	$38,000	$213	$195	$98
Projected Account Balance	$303,963	$1,705	$1,556	$778

Projection Assumptions

- Contributions continue to NRA at the current annual dollar amount, increased at a rate of 3% per year (to simulate increases in compensation)
- Investment returns are 7% per year (nominal)
- An inflation rate of 3% per year, in order to convert results to today's (real) dollars

Conversion Assumptions

- Interest: 10-year constant maturity Treasury note rate
- Mortality: Applicable Mortality Table under IRC §417(e)(3)(B)
- If married, the participant's spouse is the same age as the participant
- Payments commence immediately
- Participants are assumed to be at NRA or attained age, if older.

Plan/Participant Details	
Date of Benefit Statement	01/01/2014
Plan Normal Retirement Age	65
Current Age	40
Years Until Retirement	25
Current Account Balance	$ 38,000
Current Annual Contribution	$ 4,500

All of the results shown are estimates, not guarantees, of the level of the account balance or of the lifetime income streams of payments.

SUMMARY OF THE ANPRM

Under the proposal, participants would have to receive both their current account balance and a projected account balance in today's dollars. In addition, these must be converted to an estimated lifetime income stream of monthly payments in real dollars over the participant's lifetime with a 50% continuation to their spouse, if married. The projections must include "*easily understood*" disclosure information regarding the assumptions used and a disclaimer that the illustrations shown are merely estimates, not guaranteed outcomes.

For those liability-concerned fiduciaries, the DOL prescribes safe harbor assumptions as an alternative to the general reasonableness standard. The safe harbor assumptions and the corresponding calculations are provided in Fig. 1. Specific calculations can also be modeled on the DOL's website at www.dol.gol/ebsa/regs/lifetimeincomecalculator.html.

Conceptually, the retirement income projection and attempting to adjust participant's mindsets regarding the 401(k) plan, from wealth accumulation to monthly benefit check, is an important step in the right direction. Providing participants retirement estimates and additional meaningful information aimed at educating on retirement savings can only help to improve the overall confidence and understanding of the average participant. However, one major concept of the proposal under debate is the safe harbor assumptions.

SAFE HARBOR PERKS AND PITFALLS

Though safe harbors provide peace of mind for plan sponsors and service providers alike, it remains to be seen what the cost of these safe harbors might be. The admittedly conservative assumptions are geared at older, near-retirement participants including only inflationary raises, investment exclusively in fixed income instruments at NRA and older and providing for a modest 4% annual real return prior to retirement. One component that counteracts this conservatism are the annuity conversion assumptions that exceed many financial planners' 4%–5% drawdown concept in favor of an annuity that provides approximately 6.9% of the participant's account balance in the initial year of withdrawal based on the Applicable Mortality Table and the current 3% interest rate of the 10-year T-note (single life annuity).

For younger participants, the safe harbor salary increase assumption being no greater than inflation may have a demotivating effect. Modeling only inflationary raises for an entire career is not a realistic scenario. Perhaps age-based rates of compensation increases should be utilized. In the era of the target date fund being deemed a more appropriate default alternative than a cash investment, it is surprising that the safe harbor would support zero equity exposure beyond NRA, while professional money managers of 2010 target date funds would generally allocate in excess of 35% to equities.[1]

Another difficulty of introducing safe harbors is the static nature of some of the assumptions. With static rates of 3% inflation and 7% nominal rates of return, we are reminded of the standard interest rate range of between 7.5% and

[1] Average taken from asset allocations of 3 large mutual fund families' 2010 target date funds.

8.5% introduced by the IRC §401(a)(4) regulations. What seems appropriate at any given time may not hold true for the long term. The ANPRM describes seemingly thorough research and sound methodology with the investment performance assumptions being based on past investment performance (from 1996 to 2009) and pundit forecasts. The time snapshot referenced would make a higher rate of return seem just too optimistic, especially with the support of investment professionals forecasting lower future returns. The resulting safe harbor nominal rate of 7% mirrors a generally accepted return assumption made in many conservative defined benefit plans. While some might object that the safe harbor discount rate of 3% is excessive, it reiterates the overall conservative tone and older participant focus of the DOL's initiative.

Questions about the inclusion of safe harbors remain. Will it ease the mind of the plan sponsor at the cost of providing the participant less personalized information being tailored to the conservative nature of only a small subset of the 401(k) participant population? Will other more robust projection models be traded for the automatic compliance of a safe harbor? Will overly conservative models only serve to dissuade participants falling short of their retirement goals from contributing?

SHIFTING PARTICIPANT PERSPECTIVES

Views of the safe harbor aside, the overall goal of the ANPRM is a noble one and sets plan sponsors and service providers on the right course. As the role of the 401(k) progresses from only a supplemental retirement savings plan to the primary retirement income vehicle, so too must the perception change of the average plan participant and plan sponsor. As one commenter on the ANPRM noted, "Translating the amount saved into a future income estimate will serve to remind participants that their DC plan accumulations are needed to generate income throughout retirement."[2]

A study for the Center for Retirement Research at Boston College concluded that, "providing individuals with retirement income projections, along with related information on retirement planning, could modestly increase saving at low marginal cost. This finding suggests that it was not the income projections alone, but the *combined* effect of providing retirement planning information along with the balance and income projections that encouraged the increase in saving…"[3]

Assisting participants to gain investment and overall retirement savings knowledge empowers them to actively manage their retirement security, which may aid in altering some participants' perspectives. Some may be convinced to increase their overall savings or be deterred from taking a loan or a hardship. Other participants might roll over their account instead of taking a distribution upon termination.

For those far from their retirement goals, will they be discouraged by a projection yielding only meager monthly payments? Supplementary calculations illustrating the income advantage resulting from a 1% increase in annual contributions may have a significant effect for those with longer time horizons and may convince participants to raise their contribution rate. As DOL has noted, "Showing participants and beneficiaries the power of compound earnings may be a significant motivator to increase savings rates."[4]

One notice or disclosure will not change the entire outlook of plan participants, as was evidenced by the §404(a)(5) disclosure. However, a retirement income forecast could be useful to participants if it is coupled with additional information and an easily understood call to action.

Once participants are moved to act, plan sponsors and service providers need to be ready to answer these questions:

- What tools are available for me to further investigate my retirement readiness?
- How much of an annual increase in contributions is needed to reach my objectives?
- How else can I close the gap between my retirement target and the current state of my savings?
- How much do I really need in retirement?
- Are my goals realistic and appropriate?
- Can I retire now? If not now, when?

THE CHANGING 401(K) LANDSCAPE

Shaping participant perceptions of their 401(k) as a retirement income stream will require significant education of participants and plan sponsors alike. Proactive retirement plan specialists must be on hand to fill this education void. Phased retirement is becoming more commonplace. Plan sponsors may need to introduce in-service and flexible payment options to support stepped retirement. Older plan participants will now require additional information on best practices in retirement *spending* such as depleting after tax assets first, the merits of flexible versus fixed monthly payments, new investment company and insurance products geared at fulfilling retirement income needs, and how asset allocation affects the probabilities of outliving their retirement accounts.

Instead of being seen as a potential mandate, this notice affords plan sponsors and service providers the opportunity to shape the perspectives of participants. We can only hope that more information will spur actively engaged participants. PC

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[2] Comment No. 656 in response to the Department's Request for Information Regarding Lifetime Income Options for Participant and Beneficiaries in Retirement Plans. www.dol.gov/ebsa/regs/cmt-1210-AB33.html.

[3] Goda, Gopi Shah, Colleen Flaherty Manchester, and Aaron Sojourner. April 2013. "Do Income Projections Affect Retirement Saving?", Center for Retirement Research at Boston College.

[4] EBSA 29 CFR Part 2520.