Retirement Security: Is This What's Next After Health Care Reform?

ABA Annual Meeting
August 7, 2010

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Agenda

- Introduction
- Employee Retirement Plans: Increasing Coverage
- Retirement Contributions and Savings: Now and in the Future
- Retirement Income: Plan Investments in a Defined Contribution (401(k)) Plan World
- A Renewed Focus on Annuities in DC Plans

Introduction

A Brief History of Pension Plans

- Pension plans have been in existence since the latter part of the 19th Century
- Their period of greatest growth occurred following a Supreme Court decision in 1949 ruling that pension benefits constituted wages, and thus were subject to collective bargaining
- As time passed, it became apparent that patterns of living and working had shifted, and there were deficiencies in the retirement plan system

A Brief History of Pension Plans

- In the early 1970s, the US Senate began hearings on deficiencies in the pension plan system, including a high rate of ineligibility for pension benefits among plan participants, and the forfeiture of pension benefits despite years of service
- This set the stage for the eventual passage of the Employee Retirement Income Security Act of 1974 (ERISA)
- ERISA was enacted to protect participants and beneficiaries, and create guidelines to ensure adequate funding of retirement benefits and minimum standards for plans

A Brief History of Section 401(k) Plans

- Section 401(k) was added to the Internal Revenue Code as part of the Tax Revenue Act of 1978
- Two years after its passage, a Pennsylvania benefits consultant named Ted Benna noticed that Code Section 401(k) did not preclude pretax salary-reduction programs
  - Most people had assumed that contributions to these plans could only be made after income tax was withheld
- The IRS surprised many when it provisionally approved the first Code Section 401(k) plan, and sanctioned Benna's interpretation of the law in 1981

A Brief History of Section 401(k) Plans

- Code Section 401(k) plans quickly became a popular type of retirement plan
- Between 1985 and 1994, the value of the assets in Code Section 401(k) plans grew from $137 billion to $454.7 billion
  - By 2008, the value of the assets in Code Section 401(k) plans had grown to more than $1.5 trillion
- By the end of 1997, approximately 78% of eligible employees were participating in a Code Section 401(k) plan
  - By 2008, approximately 77% of eligible employees participated in a Code Section 401(k) plan

The Demise of Defined Benefit Plans

- Defined benefit plans are ongoing liabilities for employers because funding for these plans comes from corporate earnings (a drag on earnings can hurt a company's ability to compete)
- Lawsuits over Cash Balance Plans has affected the popularity of defined benefit plans
- The popularity of Code Section 401(k) plans has brought about a shift among employers away from defined benefit plans

The Demise of Defined Benefit Plans

- The shift from defined benefit plans to Code Section 401(k) plans has had both positive and negative effects:
  - Positive: Employees have gained greater control over their retirement assets, 401(k) plans provide both immediate and long-term tax advantages, and these plans provide certain short-term benefits, such as loans and hardship distributions
  - Negative: Employees have been compelled to shoulder more of the financial burden of their retirement (causing more uncertainty for employees) and employers have had to justify the shift from defined benefit to defined contribution plans to their employees

Retirement Plan Trends – One Survey's Summary

- A 2009 Diversified Investment Advisors survey of healthcare organizations found
  - 39% offer a defined benefit plan (down from 51% in 2008)
  - 59% of those that currently offer a defined benefit plan do not expect to make any changes in 2009
  - 4% are eliminating employer contributions to their defined benefit plans
  - 8% are reducing employer contributions to their defined benefit plans
  - 60% offer investment advice (down from 63% in 2008)
  - 46% offer managed accounts (down from 50% in 2008)
  - 68% of employees were participating in defined contributions rates (down from 70% in 2008)

Defined Contribution Plans – Where Are We?

- More Code Section 401(k) plans are now offering
  - Automatic enrollment (QACA, EACA)
  - Automatic deferral rate increases
  - Qualified Default Investment Alternatives
  - Roth contributions
  - Self-directed brokerage windows

Where do we go from here (and how do we get there)?

- Today, we will discuss the future of defined contribution plan
  - How do we increase participation in the plans?
  - How do we increase contributions to the plans?
  - How do we improve the way participants invest their plan assets?
  - How do we help participants make their plan benefits last through retirement?

Employee Retirement Plans: Increasing Coverage

What We'll Cover

- Where We Are Today
- Current Coverage Levels
- Steps Already Taken to Increase Coverage
- Cost and Administrative Issues
- Potential Legislative and Regulatory Changes

Where We Are Today

- Background – BLS Data – March 2009 (http://www.bls.gov/ncs/ebs/benefits/2009/ebbl0044.pdf)
- Decline of Defined Benefit Plans
  - Private: 20% of Employees Participate / 19% of Plans Frozen
  - Public: 79% of Employees Participate / 10% of Plans Frozen
- Rise of Defined Contribution Plans
  - Private: 61% of Employees Have Available / 43% of Employees Participate
  - Public: 30% of Employees Have Available / 17% of Employees Participate

Where We Are Today

- 50%+ of Employees Not Participating in Employer Program
- Outside IRA / Roth IRA Participation?
- Average 401(k) Account Balance - $66,900 (3/31/2010 Fidelity)
- Social Security Solvency Questions

Steps Already Taken to Increase Coverage

- Defined Benefit
  - Funding Relief
- Defined Contribution Plans
  - Automatic Enrollment – Classic, EACA, QACA
  - Automatic Increase
  - Target Date Funds
  - Increased Portability
- Sidecar IRAs

Cost and Administrative Issues

- Employer Contribution Costs
  - Defined Benefit
    - Variable Depending on Plan Funding
    - Mitigation Strategies (Liability Matching, Design Changes, etc.)
    - Can Not Be Stopped Easily
  - Defined Contribution
    - Matching Contribution Formula (*e.g.*, 50% of compensation up to 6%)
    - Easily Stopped / Requires Current Cash

Cost and Administrative Issues

- Administrative Issues
  - Staff Costs for Administration
    - Outsourcing: Pros and Cons
  - Outside of Core Business
  - Fiduciary Risks / Insurance Costs
    - Fiduciary Oversight Duties
    - Advisor Costs
    - Legal Costs
    - Staff Costs
    - Safe Harbors (QDIAs, Automatic Enrollment Preemption, etc.)

Potential Legislative and Regulatory Changes

- Potential Legislative Changes
  - Automatic IRAs
    - Required For All But Smallest Employers Without Employee Plans
    - Default Fund Issues – Small Balances, R-Bonds, Target Date Funds?
    - Fiduciary Oversight?
    - Spousal Protections?

Potential Legislative and Regulatory Changes

- Potential Legislative Changes
  - Social Security Reform
    - Individual Accounts (Like Automatic IRA)?
    - Later Social Security Retirement Age
    - Reduced Benefits
    - Increased Taxes

Potential Legislative and Regulatory Changes

- Potential Regulatory Changes
  - Increased Disclosure
    - Reporting – 3 Pieces – To Department of Labor, To Participants, To Plan Fiduciaries
    - Notices and Statements
    - Impact on Sponsorship of Plans
  - Expansion of Definition of Fiduciary
  - Updated Claims Requirements
  - More Complex Claims Litigation

Retirement Contributions and Savings: Now and in the Future

It's All About the Money: Survey Says

- Americans Lack of a Retirement "Plan" or "Needs Calculation":
  - Only 46% of workers have completed a retirement needs calculation (static for past eight years)
  - 41% of workers believe that they need at least $500,000 in savings to live "comfortably" during retirement (regardless of whether they have performed a "needs" calculation)
- Americans Do Not Set Aside Sufficient Assets for Retirement:
  - Only 69% of workers say that they and/or their spouses have "saved" for retirement (declining from 75% in 2009)
  - More than ½ of all workers report that they have less than $25,000 in total savings (excluding houses and defined benefit plans)
  - ¼ of all workers have less than $1,000 in total savings

(Retirement Confidence Survey, "2010 RCS Fact Sheet #3)

Survey Says

- Post-Retirement Savings
  - After 10 years of retirement, 29% in the second highest income quartile will run "short of money"
  - After 20 years of retirement, 13% in the first income quartile will run "short of money"
    - "short of money" means aggregate resources in retirement are insufficient to meet aggregate minimum retirement expenditures

(Retirement Confidence Survey, "2010 RCS Fact Sheet #3)

Contribution Patterns

- Current Participation Levels:
  - 51% of private-industry employees participated in a qualified retirement program
    - Impact of Unions: Union workers participation was at 80%; non-union workers participation was at 42%
  - Impact of Required Contributions for those who are offered a retirement plan option:
    - In defined benefit plans, where 1 in 25 participants is required to contribute, the participation rate is 90%
    - In defined contribution plans, where 2 of 3 participants are required to contribute, the participation rate is 70%

(U.S. Bureau of Labor Statistics, March, 2009; data from National Compensation Survey as of March, 2008)

Asset Levels (All Plans) & Budgetary Impact

- Employee Benefits-Related Tax Expenditures:
  - $380.83 billion for 2011

[EBRI, "Tax Expenditures and Employee Benefits: Estimates from the FY 2011 Budget," March 2010"]

- Current Contribution & Asset Levels:
    - Vanguard reports that median participation rate is 6% (Vanguard, 2004)
    - $16 trillion in total plan assets at year-end 2009, up $2 trillion
      - Retirement plan assets are 35% of all U.S. households' financial assets (that is, total assets are $45.1 trillion)
      - 33% of which is held in employer-sponsored retirement plans

(Investment Company Institute, "Research Fundamentals," May 2010)

Current Regulatory Environment

- Statutory Limits on Employee Contributions
- Statutory Limits on Employer Contributions
- Recent Developments to Encourage Increased Contributions/Plan Features

Current Participant Contribution Limits (401(k) Plans)

- Internal Revenue Service Limits:
  - Flat Dollar Amounts (IRC 402(g): as adjusted for cost-of-living increases
    - 2010 Maximum 401(k) contribution $16,500 per participant
    - 2010 Additional “catch-up” contribution $5,500 for participant age 50 or other
  - Discrimination Testing Implications:
    - Actual deferral and actual contribution percentage tests and related exemptions: Safe harbor contributions
    - Top-heavy tests: 3% contributions
    - Compensation definition implications: Compensation capped at $245,000 per participant

Trends and the Future of Contribution Limits (401(k) Plans)

- Automatic (Negative) Enrollment (employee-focused):
  - Auto default opt-out program commencing in 2000
  - Studies show that participation rates increase, but that deferral rates decrease
  - Automatic escalation

Employer Contributions (401(k) Plans)

- Employer Contributions:
  - Matching contributions:
    - 25% of plan sponsors offer a match
    - Generally up to 6% of eligible compensation
- Safe Harbor Provisions (employer-focused)
  - General:
    - Multiple types of safe harbor contributions
    - Provides for mandatory employer contribution (e.g., 3% non-elective and matching contribution of between 3-4%)
    - Provides "relief" for vesting of employer contribution (e.g., full vesting to two year vesting schedule)
    - Provides "relief" for discrimination testing
    - Requires participant notices
  - QACAs: Tied to automatic default program

Plan Design Considerations (401(k) Plans)

- Plan Design Features Impact Contribution Rates:
  - Loans (6% differential in coverage—GAO, 1997)
  - Hardship Withdrawals
  - Complexity of Investments

Funding Considerations in Defined Benefit Plans

- Mercer estimated a 400% increase in employer-required contributions to defined benefit plans from 2008 to 2009
  - An increase to $5 billion from $1 billion

(Mercer, "Estimated 2010 Required Contributions and Credit Balances, "02.03.10)

Social Security Contributions & Benefits

- Social Security Expenditures:
  - Expenditures of the program were estimated to be 4.9% of GDP in 2009
  - 41.6 million beneficiaries in pay status in 2008; projected to be 43.2 million in 2010, 79.1 million in 2040, 104.8 million in 2085

(EBRI, “Facts,” July, 2009)

- 2010 Social Security Amounts:
  - Maximum Taxable Earnings: $106,800
  - Benefits at “full retirement age”: $37,680/year (or $3,140 per month)
  - Full retirement age depends on the year you were born; if you were born in 1960 or later, full retirement age is 67

Other Vehicles for Retirement Contributions

- IRAs:
  - Recent estate planning directives to utilize ROTH IRAs as rollover vehicles
  - Auto-IRA introduced by U.S. Senator Bingaman
    - Required of employers with more than 10 employees who do not otherwise have a retirement program
    - Automatic IRA with mandatory employee default at 3% (employee can opt-out)
    - Employer cannot contribute; employer receives tax credit for administrative costs

New Developments: Behavioral Finance

- Initial Premise: Individuals Act to Make Economically-Rational Decisions
- Reality:
  - Individuals focus too much on the present
  - Individuals discount the value of the future
- Impact:
  - Plan design can impact participant results

(See, AARP, "Designing 401(k) Plans That Encourage Retirement Savings: Lessons From Behavioral Finance," IB, No. 80)

Next Steps . . .

- Address Behavioral Finance Impact:
  - Increase automatic escalation
  - Increase automatic enrollment default percentages
  - Review opt-out participants after specified period
- Increase Dollar Limits
- Provide Greater Flexibility Regarding Discrimination Testing

Retirement Income: Plan Investments in a Defined Contribution (401(k)) Plan World

Introduction

- Defined benefit plan decline and defined contribution plan dominance
- Current inadequacy of defined contribution account balances as a source of retirement income for majority of working employees
- "Adequacy" a function of savings rate (both employee and employer); investment allocation; expenses; and period of accumulation

Brief History of Defined Contribution Plan Investments

- Pre-ERISA: defined contribution plans largely employer-directed
- ERISA (1974) spurred participant self-direction of investments
- 401(k) Proposed Treasury Regulations (1981)
- Proposed ERISA §404(c) regulations(1987)
- Mutual fund trading platforms and daily valuations (late 1980s, early 1990s)
- Brokerage windows
- Parallel development of risk-based and target date retirement portfolios starting in late 1980s
- From 1995 to 2005, average number of funds offered more than doubled (6 to 14)
- Federal district court decision this year reported that Unisys 401(k) plan has more than 70 investment choices

Some Sobering Facts About Participant Investing IQ

- 65% unaware that bond funds can lose money; 44% believe that money market funds include stocks; 20% unaware that stock funds can lose money [Greenwald Associates]
- In 2009, average plan participant using a plan's "core menu" (of ten or more funds) had investment performance almost 10% less than an asset allocation fund (risk-based or target date) [Hewitt Associates]
- Estimate that poor asset allocation "costs" from 60 to 350 basis points in expected real return per year [Pension Resource Council]
- Even smart lawyers are often dumb investors
- Plan participants – whether because of lack of knowledge, lack of ambition or lack of time – appear to be largely unequipped to make investment decisions that would improve retirement income adequacy

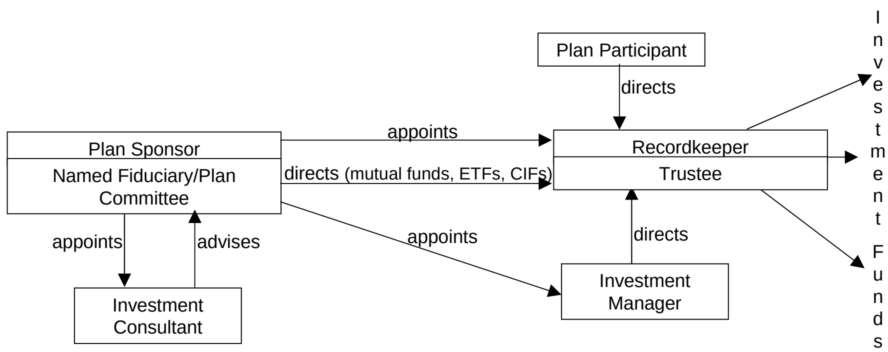
Roles of the Plan Sponsor

- Selection of plan investment alternatives
- Investment education
- Investment advice

Named Fiduciary Selecting/Monitoring Plan Investment Alternatives

- ERISA §404(c)
  - Participant makes investment decisions using plan offerings
  - At least three diversified investment alternatives
  - In a plan that complies with §404(c), participant investment decisions, including appropriate default investment alternatives, will not result in fiduciary liability for plan sponsor, plan committee or other plan fiduciary
  - However, plan fiduciary (the "named fiduciary") that selects and monitors investment offerings not relieved of fiduciary responsibility for those alternatives
  - §404(c) has many information requirements, with easy traps for the unwary that can lead to loss of §404(c) protection
  - Self-audits of §404(c) compliance recommended
  - Details in memorandum included with presentation materials

Allocation/Delegation of Fiduciary Responsibility



Investment Education and Advice

- Need for investment information/education for retirement plans with participant investment direction
- Desire of plan sponsor to assist participants with investment decision-making
- Competing desire of plan sponsor to avoid becoming a fiduciary by reason of providing individualized investment advice
- U.S. DOL regulations provide “safe harbor” for certain types of investment education that will not cause plan sponsor to become an investment advice fiduciary
  - plan information
  - general financial and investment information
  - asset allocation models
  - interactive investment materials

Investment Education and Advice (cont'd)

- Plan sponsor may also contract with a provider of individualized investment advice to plan participants
- Plan sponsor's selection and monitoring of participant investment educators and investment advisors are fiduciary decisions subject to ERISA's prudent expert standard
- Relatively low usage of investment advice: 7%-8% utilization rate (advice); 2%-3% utilization rate (managed accounts) [T. Rowe Price]

Paralysis of Choice

- Unisys plan: more than 70 fund choices!
- Evidence that plan participation may decline as the number of fund offerings increases
- Fund usage per participant may be in low single digits despite explosion in number of fund offerings
- Increase in number of fund choices may increase investor conservatism
- Is more necessarily better?

Back to the Future?

- NCR Corporation (early 1990s) offered asset allocation (risk-based) funds as only alternatives in its defined contribution plan
- Target date retirement and risk-based funds
  - Off-the-shelf or custom
  - Structural considerations
    - Risk profile
    - Glide path
    - Active or passive (index)

Back to the Future? (Continued)

- Target date retirement and risk-based funds (Cont.)
  - Legal considerations
    - Target-date and risk-based funds require prudent selection and monitoring, as with any investment alternatives
    - Require clear understanding of asset allocation over time (glide path) and underlying asset components (managers, track record, fees, etc.)
    - DOL Investment Bulletin: Target Date Retirement Funds (5/6/10)
    - SEC concern regarding disclosure and marketing materials (6/16/10 open meeting)
- Employers as leaders rather than followers in simplifying investment alternatives

A Renewed Focus on Annuities In DC Plans

Why Now?

- An attempt to address risks illuminated by the combination of recession and the increasing reliance on defined contribution plans as primary retirement vehicle.
- Risks include
  - Longevity risks (*i.e.* outliving retirement savings)
  - Insufficient accumulation of retirement savings
  - Investment risks (prolonged exposure to higher risks)
  - Inflation risks (loss of buying power)

Renewed Focus on Annuities

- DOL/Treasury has requested public comments to determine whether it should consider acting regarding annuities.
- What are the advantages and disadvantages?
- What do participants need to know?
- What products are being developed?

Renewed Focus on Annuities

- Senate's Special Committee on Aging held a hearing to discuss lifetime income options
- Testimony/Statements from Phyllis Borzi, Assistant Secretary of Labor, Employee Benefits Security Administration; Mark Iwry, Deputy Assistant Treasury Secretary for Retirement and Health Policy; AARP, American Academy of Actuaries and many providers in the insurance and investment field

Renewed Focus on Annuities

- General comments gleaned from testimony and statements submitted
- The decline in defined benefit plans and the ascendancy of defined contribution plans has put more of the previously named risks for retirement security on employees
- Inadequate retirement savings is not likely to be cured by lifetime income distribution options any more than by adding default investments

Renewed Focus on Annuities

- Longevity risk can be mitigated by lifetime income options
- Risk pooling or institutional pricing is critical to economically efficient lifetime income options

Annuities of the Past

- Employers have always been permitted to offer annuities under 401(k) plans but such annuities fell in disfavor over the years largely due to regulatory complexities and lack of interest by participants
- Offering annuities requires compliance with spousal consent rules and other qualification requirements.
- Participants did not elect annuities when offered
- Selection of an annuity provider also introduced some fiduciary risk that the provider would be unable to make the promised payments (Executive Life, etc.)

Why Annuities Are Unpopular

- Participants want control over their money
- Amount of a lump sum often represents the largest amount of cash ever made available to a participant and is irresistible
- Fear of outliving principal paid for an annuity
- Desire for liquidity in the event of hardship
- Lack of death benefits in annuity
- Absence or expense of inflation protection in annuity
- Solvency risk of employer or annuity provider

Advantages of Annuities

- Lifetime security
- Reduces responsibility to manage investments
- Risk pooling offers economic advantage to “self insuring” for longevity risk

Ideas Offered

- Over 800 comment letters were submitted to the DOL and can be viewed on the DOL/EBSA website
- Numerous statements accompanied testimony before the Special Committee on Aging

Ideas Offered

- Partial annuities should be offered in order to maximize flexibility for participants with different situations and needs
- Risk pooling is critical to reasonable pricing
- Education is needed to reintroduce annuities and ensure participants understand the cost, benefits and risks of lifetime income options
- Longevity insurance may be beneficial but may need to amend IRC 401(a)(9) to accommodate (longevity insurance is an annuity deferred until very late, i.e. at or near life expectancy)

Step Previously Taken by DOL

- DOL recently issued safe harbor rules for fiduciaries under defined contribution plans for the selection of annuity providers
  - The safe harbor requires a thorough, objective and analytical search
  - Consideration of the financial health of providers
  - Consideration of the cost of the annuities (fees and commissions)
  - Use of an expert if needed

Challenges Remain

- How do you build inflation protection into annuities? Is a partial annuity enough?
- Is there an economic way to add refund features or or period certain annuities?
- Will participants elect annuities if offered?
- How do we minimize solvency or default risk of providers?

Future possible developments

- Insurance companies will continue to work on new offerings (adding annuities to target date funds)
- Providers are exploring ways to pool and diffuse risk of provider liquidity
- Various parties are exploring government guarantees
- Providers are exploring ways to offer better evaluation of annuity providers to enable smarter and cheaper annuity purchases

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