

Washington update: 2010 year in review

How Washington is addressing defined contribution shortcomings

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With the passage of the Pension Protection Act of 2006 (PPA), the economic downturn in 2008 and increased governmental and legal scrutiny, the defined contribution (DC) retirement plan landscape has undergone a sea of change in terms of its structure, form and focus. The year 2010 saw significant regulatory activity. The Department of Labor (DOL) and the Securities and Exchange Commission (SEC) have attempted to shape the DC industry through regulation that clearly defines the duties of plan sponsors and the vendors that serve them. Although it often seems that Washington and the general public are at odds, and while the additional regulation can be burdensome, the actions seem to be aimed at shoring up the current system as opposed to tearing it down.

What is driving the change?

By all accounts, DC has supplanted defined benefit (DB) as the primary retirement savings vehicle for many Americans. Yet, we know it's a far from perfect system. Defined contribution plans perform, on average, approximately 1% worse than defined benefit plans do, which leads many to conclude that they are inefficient¹. Further, there is no mandatory savings on behalf of the employee or employer, and participants seem reluctant to do it themselves. In that context, the regulatory activity can be viewed as addressing five key gaps of the current DC system: better coverage, better participation, better investments, better retirement income solutions and better understanding of fees.

Key developments in 2010:

- Auto-IRA Bill
- SEC and DOL joint guidance on target date funds
- SEC proposal on target date funds' marketing materials
- DOL provider-to-sponsor interim final rule on fee disclosure
- DOL sponsor-to-participant interim final rule on fee disclosure
- DOL proposed redefinition of "fiduciary"

¹ Source: Towers Watson, *Defined Benefit vs. 401(k) Investment Returns: The 2006-2008 Update*, 2009

Better coverage: Auto IRA bill

Roughly half of the U.S. workforce, or about 78 million Americans, have no employer-based retirement plan.² The majority work for small businesses, or in uncovered groups in larger companies; are self-employed; or are seasonal or temporary workers. To address this issue, in July 2010 Congress introduced a bill that would require most businesses; if no other workplace retirement plan option is offered, to automatically enroll participants into an IRA-type account.

This segment of the market presents challenges for providers. First, most of these plans would have small balances, making economies of scale difficult to achieve and plan administration costly relative to the revenue generated. Further, the “default investment” issue would also be contentious, when plan sponsors, small in size and resources, are obliged to make difficult decisions without the benefit of special training or expertise; the fiduciary liability could prove to be too much for them to handle. Lastly, the U.S. Treasury’s incremental lost revenue from tax deferrals could make this bill extremely difficult to pass in today’s economic environment. That being said, the lack of coverage for so many Americans is a real concern in Washington, and we should expect this issue to be addressed in the coming years.

Better participation: The Pension Protection Act of 2006 (PPA)

Back in 2006, the PPA attempted to address the question of how to get workers whose employers offer a retirement plan to participate and to contribute more. Over the past ten years, the average plan participation rate has languished at between 74% and 77%.³ The PPA provided safe harbor for those plans that automatically enrolled participants as long as the plan met certain criteria. As a result, the number of plans utilizing auto programs rose from 14% in 2001 to 58% by 2009.⁴ The figures also indicate that the average participation rate slowly increased during the recession of 2008, but was most likely muted by the downturn in the markets. At the same time, participation rates were significantly higher for those plans that adopted automatic enrollment (86% vs. 45%) than for those that did not.⁵ So, how successful was the PPA in moving the needle toward greater participation? While the industry was moving toward these solutions on its own, the PPA clearly accelerated the adoption of such programs. Time will tell how well these measures have closed the gap.

Better understanding of investments: SEC and DOL guidance on target date funds

There is a tangible lack of understanding about how target date funds work, among the investing public and plan sponsors as well. In a recent survey conducted by Envestnet Asset Management, 62% percent of participants believed they could retire on a fund’s target date; 38% believed target date funds would produce a guaranteed return; 30% believed they could save less with such funds and still meet retirement goals; and 41% thought there was no risk of losing money in any one-year period with target date funds.⁶

² Annual report of the White House Task Force on the Middle Class, 2010.

³ Vanguard, “How America Saves 2010.”

⁴ Hewitt, “Trends and Experiences in 401(k) plans 2009.”

⁵ Vanguard, “Measuring the Effectiveness of Automatic Enrollment,” 2008.

⁶ Investment News, “Employees don’t understand target funds, survey shows,” 2009. Available at <http://www.investmentnews.com/article/20090510/REG/305109970>.

These findings clearly indicate that there is a great deal of confusion about what target date funds are and how they work. To address this lack of understanding, Washington is working toward mandating greater disclosure requirements.

In the meantime, the **SEC** and the **DOL** have issued the Joint Investor Bulletin on Target Date Retirement Funds (May 6, 2010).⁷ In this four-page document, the two agencies outlined several considerations for investors in target date retirement funds. Among them are the importance of understanding investment style; the fund's prospectus; how investments change over time; the fund's fees; and spending needs in retirement.

Although the bulletin is not regulation per se, it does clarify how the DOL and SEC want participants and sponsors to evaluate the target date retirement funds in which they invest. They have essentially provided a roadmap for doing so.

To further explain its position, the SEC issued a rule proposal on June 16, 2010 regarding the marketing of target date funds. The proposal, which is expected to become regulation, would require greater disclosure and uniformity of disclosure in target date fund marketing materials. Elements of the proposal include:

1. Marketing materials with the target date in the name would also need to disclose the asset allocation at the end date;
2. The types of investments to be used would also need to appear near the fund name, the first time the fund's name is used;
3. Marketing materials would need to include a prominent graph, table or chart depicting the asset allocation and how it changes over time;
4. A statement (immediately preceding the graph, table or chart) "explaining that the asset allocation changes over time, noting that the allocation eventually becomes final and stops changing, stating the number of years after the target date at which the allocation becomes final, and providing the final asset allocation."⁸

As of November 30, 2010, the DOL has proposed target date rule changes that, if adopted, would amend the qualified default investment alternative (QDIA) regulations. These rule changes are similar in scope to the SEC proposal, and plan sponsors who wish to remain compliant will need to include them in future disclosures. The DOL also will publish a series of tips, intended to serve as a checklist, to help plan fiduciaries obtain and evaluate relevant information when selecting and monitoring target date funds. Fiduciaries will be required to provide more disclosure, to be sure, but regulators hope the end result will be that fiduciaries engage in a prudent, well-documented process that explains, in the simplest and clearest terms, the rationale for their target date decisions.

Better retirement income solutions: hearings and investigation

An issue that is coming to the forefront of the industry is the insecurity of income during retirement. DC plan participants have to juggle the responsibilities of budgeting, saving, allocating assets and decumulation – a process that DB plans have put on automatic pilot. Decumulation involves several risks, including the effects of the market, inflation, longevity, interest rates and more. No product currently addresses all of these risks at once while still offering a cost-effective solution. Lack of knowledge and behavioral biases exacerbate the difficulty for participants.

⁷ Available at <http://www.dol.gov/ebsa/pdf/TDFInvestorBulletin.pdf>.

⁸ SEC Interim Final Rule on Target Date Fund Marketing: <http://www.sec.gov/news/press/2010/2010-103.htm>

Some plan sponsors have considered vehicles with a guaranteed-income component embedded. However, the acceptance of such products to date has been limited, due to regulatory uncertainty and the products' cost and complexity. There is also enormous fiduciary risk in choosing a provider of an income guarantee. To date, less than 7% of plans offer any sort of packaged retirement income solution.⁹ Some believe that if the government were to allow some safe harbor provision for sponsors who implement such a retirement income solution, greater acceptance by plans is probable.

The government looked into these options in 2010. The DOL and the Treasury put forth a request for information (RFI) on retirement income products, and many interested parties responded with their opinions. A joint DOL-Treasury hearing on the subject was held in mid-September. Russell addressed the specific topic of disclosure for participants. The testimony, presented by Bob Collie, discussed the need to provide participants with account disclosures that communicate their balances on the basis of how much income they can produce, not merely their current value. Bob successfully argued that this is a critical first step in moving the mindset around DC plans to envisioning a retirement plan, not just a savings plan.

It is not clear from the hearings whether any of the current offerings – such as fixed or deferred annuities, payout funds, longevity insurance and guaranteed minimum withdrawal benefits (GMWBs) – will gain the regulatory seal of approval. All of these options have inherent weaknesses and trade-offs. However, the increased awareness of annuity products in DC plans will surely stir up interest among plan sponsors in implementing a retirement income solution. While the DOL has been on record as saying it is not looking to mandate these features, its actions indicate a positive view of retirement income solutions as a whole.

Better fee disclosure: The DOL's three-part effort

Perhaps the biggest challenge faced by plan sponsors today is the lack of transparency in the fees they pay to vendors and fund providers. Although bundled solutions have some advantages, giving sponsors the ability to break out fees and adequately understand them requires an additional push from regulators. The DOL has tackled this in three distinct ways.

1. In 2008, the DOL (with the IRS and the Pension Benefit Guaranty Corporation) amended the filing requirements for Form 5500 to include more information about fees paid to service providers.
2. On July 15, 2010, the DOL issued an interim final rule on fee disclosure as it applies to provider-sponsor communications. Although a formal contract is not required, fee disclosures must be in writing. Disclosure of conflicts of interest, such as record keeper and fund management revenue sharing, will need to be clearly described. Providers of bundled services will be required to separately disclose to sponsors the cost of record keeping and services.
3. On October 14, 2010, the DOL issued a final rule regarding fee transparency in communications from sponsor to participant. This rule states that plan beneficiaries must regularly be provided with certain plan-related information, such as investment options, fees for general administrative expenses, legal expenses and any expenses borne directly by the participant. This information must be given at the time the participant enrolls, and at least annually thereafter. Additionally, investment information – such as performance,

⁹ Hewitt, "Trends and Experience in 401(k) plans 2009."

benchmarks, investment management fees, web sites, and a glossary of terms – must be made available.

We believe this will ultimately shed light on the fees paid by plans and participants and level the playing field for record keepers, fund managers and consultants.¹⁰ In turn, increased competition and understanding will likely reduce fees. Everything a sponsor pays for will have to be justified, and plan sponsors will be measuring fees against benchmarks that previously did not exist.

Both sponsors and participants will need help in benchmarking all of the new information. They will then have to determine which fees are reasonable and which are excessive, and to understand that the cheapest option is not always the best. The goal is to ensure that the plan sponsor understands and can justify its decisions.

Plan sponsors will need to focus on fees as much as on their investment decisions. The industry has already seen class-action lawsuits wherein sponsors are held liable for conducting insufficient due diligence on fees, and we expect this will continue as long as a disclosure gap exists.

A new definition of “fiduciary”

On October 21, 2010, the DOL released its proposed rules regarding the definition of “fiduciary.” Covered persons under the proposed rule’s expanded definition include any provider or person that exercises discretionary control or management over assets, provides advice for a fee or has discretionary authority over the plan’s administration. The consequences of this revision are that more of the providers who touch a plan are now held to a higher standard in their practices. ERISA fiduciaries have a duty to act for the exclusive purpose of providing plan benefits and defraying reasonable expenses of the plans they serve, and thus are liable for any losses associated with a breach of these duties.

Over the next few months, it is certain that compliance and legal departments will be working furiously to define where and when they are acting as fiduciaries to clients. Regulators also will have to catch up and more closely monitor those who now fall under the expanded definition.

Conclusion

The combined efforts of defined contribution industry stakeholders have enhanced the role of the 401(k) in retirement planning, but significant headwinds still exist. Increased fiduciary pressures, operational complexities, product focus, confusion about fees, and post-retirement outcomes have given plan sponsors reason to pay increased attention to the details of plan design, vendor selection and communication.

Concurrently, Washington is working toward closing the perceived gaps in the DC system. Plan sponsors need to pay attention to what is happening in Washington, to lobby and educate legislators and regulators and to stay ahead of the trends to make sure their DC plans are the best they can be. Russell will continue to monitor current topics and provide insight to plan sponsors.

Although it is likely that Washington’s regulators will focus on “nudge” strategies that encourage improvements to retirement plans, legislators have their eyes on the DC system and are prepared to take drastic measures if the industry does not self-police. Representative George Miller, a Congressman active on this topic, has even said that “the savings rate isn’t going up for the investment of \$80 billion,” referring to the

¹⁰ Gardner, Daniel and Teborek, Mark. “Washington Update: Participant fee disclosure and its implications for 401(k) plan sponsors,” 2010.

Treasury's lost revenue from tax deferrals due to the cumulative tax breaks for employee deferrals. "We have to start to think about . . . whether or not we want to continue to invest that \$80 billion for a policy that's not generating what we now say it should."¹¹ Although Washington is not ready to sponsor a complete government overhaul of the private retirement system, Representative Miller's statement should serve as a caution to plan sponsors and providers: pay attention to your plans, and take active steps toward repairing their weaknesses.

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¹¹House Democrats Contemplate Abolishing 401(k) Tax Breaks, October, 2008. Available at <http://www.workforce.com/section/news/article/house-democrats-contemplate-abolishing-401k-tax-breaks.php>.