



FIDUCIARY CONSIDERATIONS FOR INSURED RETIREMENT INCOME PRODUCTS:

FOCUS ON GUARANTEED WITHDRAWAL BENEFITS

by

Fred Reish & Bruce Ashton

Introduction

In light of the shift in the last several decades from defined benefit pension plans to defined contribution plans – particularly employee-funded, participant-directed 401(k) plans – there is increasing concern about whether employees will be able to live on their 401(k) savings in retirement. That is, will they have enough money when they retire? And will they withdraw it in a way that won't exhaust their funds before they die? This paper discusses important fiduciary considerations for evaluating insured retirement income products. It focuses on a new generation of insurance products designed to address these concerns...guaranteed minimum withdrawal benefit features, or GMWBs, but the principles apply to any products with insured guarantees, including deferred annuities and guaranteed minimum income products.

Research has shown that, if retired participants withdraw more than 4% or 5%, inflation adjusted, of their account balance per year, there is a significant possibility that many will run out of money during retirement.¹ Based on this – and the lack of widespread acceptance of traditional annuity products – the 401(k) community and the investment and insurance industries have been working to develop other “solutions” – guaranteed withdrawal programs – that will ensure retired participants that their money will last for their lifetimes.

The new GMWB products consist of an investment option – typically, a balanced fund (e.g., a lifestyle fund) or a target date fund – together with a *guaranteed minimum withdrawal benefit*. A GMWB guarantees a specified level of benefits for life if a covered participant exhausts his retirement savings. The participant retains control over the principal, *i.e.*, his account balance in the plan or IRA (so long as it is invested in one of several approved funds, e.g., target date or balanced funds). A participant pays a premium to the insurance company from his account; and, so long as he takes distributions out of his account in accordance with a set schedule (usually, for a retiree at age 65, 5% of his “benefit base” – defined below – each year²), the insurance company agrees to pay the participant a guaranteed benefit in retirement if his account is depleted during his lifetime. If the funds do not run out, at death the remaining value of the investments can be left to the participant's beneficiary.

The primary purpose of a GMWB feature is to provide participants with a minimum guaranteed income for their lives (or jointly with the life of the spouse), regardless of

¹ William P. Bengen, Determining Withdrawal Rates Using Historical Data Journal of Financial Planning, October 1994, pp. 14-24.

² For participants who begin taking distributions at an older age, the percentage of the benefit base they may withdraw will be higher.

fluctuations in the market value of their accounts, and regardless of how long they live, provided they observe the feature's requirements.

The decision to offer an investment with a GMWB feature in a 401(k) plan is a fiduciary one. Not all GMWBs are the same. For this reason, before offering GMWBs, fiduciaries should engage in a prudent process to assess whether to offer such a feature and if so, which one to offer.

This paper discusses the legal standards governing a fiduciary's decision to offer a GMWB, particularly in choosing the insurance carrier that offers the feature. It provides fiduciaries with a starting point for that process. Before discussing these issues, we describe the typical characteristics of the GMWBs currently available in the marketplace.

Typical Features of a GMWB

The following are the typical elements of the GMWB feature:

- The feature is generally tied to specified investment options offered by the 401(k) plan, generally a target date fund or a balanced investment portfolio, such as a conservative, moderate or growth lifestyle fund. These portfolio-type investments are used because they enable the insurance company to evaluate and manage the risks they are insuring. In addition, the participants will be investing in a manner contemplated under ERISA's fiduciary rules, for example, consistent with generally accepted investment principles, such as modern portfolio theory.

The benefit base is the participant's highest account balance, which can be increased by employee and employer contributions and investment earnings. (The benefit base is typically reset on a participant's anniversary or birthday. However, the benefit base is never reduced so long as the GMWB requirements are followed.) Further, it is not reduced by distributions to the participant in retirement so long as he does not, for example, take more than a specified percentage of the benefit base each year (at age 65, it is usually 5%, if predicated on the participant's life, or 4½% in the case of a joint and survivor guarantee with a spouse). Thus, the base amount can go up, but not down, except for excess retirement distributions, loans and transfers to other investment options.³

- The participant is charged an annual fee – or premium – for this feature, which

³ For ease of discussion, we assume that the participant using GMWB has invested 100% of his plan account balance in the specified investment, though this is not required. Unless otherwise stated, we also assume that the participant retires and the distributions are post-retirement. We also use "account" to refer to both a participant's 401(k) account and a retiree's rollover IRA.

typically ranges from 50 basis points per year (0.50%) to 100 basis points (1.00%) and is in addition to the management fees for the investment. (The differences in the fees are typically related to the terms and conditions of the guarantees, that is, the higher premiums usually equate to some improvement in terms or coverage.)

- In exchange for the premium, the insurance company agrees to pay the participant a benefit equal to a set percentage (*e.g.*, 5%) of the benefit base (or “high water mark”) if the funds in the participant’s account are exhausted during retirement. If the participant’s account is never depleted, the insurance company is not called on to pay the guaranteed amount. And, if the participant dies before the account is exhausted, his remaining account balance goes to his beneficiary. However, the GMWB does not guarantee that the participant’s account value will not be depleted; instead, it guarantees payments for life if the account balance is depleted.
- The payment of the premium continues for the duration of the guarantee, that is, until and unless the account is exhausted and, therefore, until the guaranteed payments commence.
- Beginning at retirement, a participant who elected GMWB coverage may withdraw from his account (which must continue to hold one of the specified eligible investment options) more than the set distribution amount (*e.g.*, more than the 5% per year for a participant who retires at 65), up to and including the entire balance in the investment. However, withdrawals in excess of the set amounts will reduce the benefit base and thus the guaranteed amount and result in reduced guaranteed payments by the insurance company. (Note that there is, in most products, an exception if the withdrawals are due to the minimum required distribution rules).

Evaluating GMWBs

General Fiduciary Standards

Whether to offer GMWBs or similar products to retirement plan participants is a fiduciary decision. As with any investment or product to be offered to plan participants, 401(k) plan sponsors (or the fiduciaries responsible for administering the plan) must engage in a prudent decision-making process. Should the plan offer a GMWB? If so, which one? And which carrier should be selected and how should it be evaluated? After

making the initial decision, and as time goes by, the fiduciaries must periodically re-evaluate (or monitor) the decision to make sure it continues to be valid.

These decisions are governed by the fiduciary standards of ERISA, including the prudent man rule, which requires that fiduciaries engage in a prudent process to make decisions. In addition, a fiduciary must discharge his duties solely in the interest of the participants and for the exclusive purpose of providing benefits.⁴ These are referred to as the duty of loyalty and the exclusive purpose requirement.

The fiduciary duties and steps discussed in this Paper with respect to the selection of a GMWB are the same standards that apply to any fiduciary decisions, such as the selection of service providers or investments. Though the selection of a GMWB may involve slightly different issues, the process that fiduciary should use, the steps they should take and the ultimate decision they make are not subject to any higher standards than those to which fiduciaries are already held.

In carrying out these duties, fiduciaries must act carefully, skillfully and diligently, in the way a knowledgeable person (about these types of products, *i.e.*, GMWBs and these types of providers, *i.e.*, insurance companies) would act in operating a similar enterprise (*i.e.*, a participant-funded and participant-directed retirement plan), taking into account changing circumstances as they evolve.⁵ The focus of this “prudent man” or “knowledgeable person” standard is on conduct rather than results – what process did the fiduciary follow in making decisions?

The Department of Labor (DOL) has described a number of steps in this “prudent process”:

- (1) fiduciaries must determine what information they know or should know is relevant to the decision;
- (2) they must obtain the information needed to make the decision through data gathering;
- (3) they must evaluate the information; and
- (4) they must make a decision based on the information that has been gathered and analyzed.⁶

A proper investigation of the issues is the first part of the duty, and results in the

⁴ ERISA §404(a).

⁵ ERISA §404(a)(1)(B).

⁶ ERISA Regulation §2550.404a-1.

fiduciaries being informed.⁷ This in turn makes possible the second part of the duty, which is to make a prudent decision that has a reasonable connection to the relevant information discovered through the investigation.⁸ Stated slightly differently, the output of the prudent process is the making of an “informed and reasoned” decision.

By stating that a fiduciary must act prudently “under the circumstances then prevailing,” ERISA requires a fiduciary to initially consider current conditions (but not to have a crystal ball about the future) and then to revisit his decision periodically, as circumstances change, to ensure that it continues to be a prudent decision. This latter obligation is referred to as the duty to monitor, which must be carried out using the same process as the initial decision.

Considerations for Evaluation GMWBs

What are the relevant considerations in deciding whether to offer a GMWB and, if so, which one? Among the relevant factors are:

- The current financial strength of the insurance company offering the feature; that is, at the time the decision to offer the GMWB is made, is there a reasonable basis to believe that the insurance company will be financially able to make all future guaranteed payments if it is required to do so?⁹
- The premium cost of the GMWB and the fees and expenses of the underlying investment option to which the feature is attached;¹⁰
- The features of the product generally;
- The portability of the feature – that is, portability by a participant to a different 401(k) plan if he changes jobs, the ability to continue the feature if the participant’s benefit is rolled over to an IRA, and the continued availability of the feature if the plan sponsor changes providers; and
- The education provided by the insurance company so that participants can understand and decide whether it is appropriate for them – particularly with respect to the impact of withdrawals that exceed the guaranteed minimum.

A discussion of each of these considerations is beyond the scope of this Paper, but we focus on three of them: (1) product features; (2) portability of the feature; and (3) the financial viability of the insurance company that provides the feature.

⁷ See, generally, *Riley v. Murdock*, 890 F.Supp. 444, 458 (E.D.N.C. 1995).

⁸ *Fink v. National Savings and Trust Company*, 772 F.2d 951, 962 (DC Cir 1984).

⁹ See, e.g., ERISA Regulation §2550.404a-4(b)(4)

¹⁰ *Id.* at subsection (b)(3)

In the Preamble to its regulation on the selection of qualified default investment alternatives (QDIA), the DOL stated that in selecting a particular QDIA, fiduciaries must “engage in an objective, thorough, and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate.”¹¹ While this relates specifically to the selection of a QDIA, the point being made can easily be applied to the selection of a GMWB product and its provider.

1. *Evaluating Product Features:* The fiduciary process for selecting a GMWB investment is substantially the same as the process a fiduciary should use in selecting investment options offered under a plan generally. That is, after evaluating the needs of the participants in the plan and determining that it is appropriate to offer an investment option that includes a GMWB feature, the fiduciary should engage in a prudent process to compare the competing products in the marketplace; giving consideration to such issues as the performance of the underlying investments; the age or service requirements for the guarantee to go into effect, if any; the way in which the benefit base is determined; the cost of the feature compared to the benefits it provides; the materials made available by the provider to educate the participants about the product; and the like.

The fiduciaries must also consider the cost, such as fees and commissions, of the contract in relation to the benefits and administrative services to be provided. The prudence requirements do not require that fiduciaries select the “cheapest” provider. However, each provider’s costs should be considered relative to the features, benefits and services that will be provided.

2. *Portability.* There are several issues regarding the “portability” of a GMWB that fiduciaries should consider:
 - (i) Is the GMWB transferable if the employer switches providers?
 - (ii) Is the GMWB transferable to another plan or IRA, and at what cost?

For the first question, a fiduciary should assess whether the feature (and the premiums paid by participants) is lost if the fiduciary decides to change providers.

In other words, the fiduciary should consider whether the feature is transferable and the impact on participants if it is not. If it is transferable, then the fiduciary

¹¹ Preamble to DOL Regulation Section 2550.404c-5, 72 Fed Reg 60452 (October 24, 2007), at 60460-60461.

should evaluate any costs that apply above and beyond the premiums already paid.

As to the second question, fiduciaries should consider the portability of the feature from one plan to another, that is, whether the GMWB feature is transferable if an electing participant leaves and seeks to transfer his account balance to his new employer's plan or to roll over his account balance to an IRA. Some providers allow the participant to retain the GMWB feature upon rollover to an IRA maintained with that same insurance company.

As a general statement, the loss of a benefit or feature upon transfer to another provider is not a *per se* violation of ERISA's fiduciary responsibilities. For example, a fiduciary may properly decide that such a transfer benefits the participant population as a whole, even though some participants may lose a plan feature.

3. *Selecting the Carrier.* The primary value of the GMWB is the insurance company's promise that the participant will continue to receive income for life following his retirement, even if his account balance is depleted. In selecting a GMWB provider, prudent fiduciaries must appropriately consider information sufficient to assess the ability of the insurance company to make future payments if it is required to do so. Under ERISA, this assessment is made based on information available at the time of the decision; a fiduciary is not required to have a crystal ball to ensure that the insurance company will be able to make the payments many years into the future. However, the decision must be monitored along the way, and provisions related to portability and contract termination need to be considered in this context.

There is no direct guidance on how this decision should be made, though the DOL addressed a similar fiduciary issue in 2008.¹² Specifically, the DOL created a safe harbor for satisfying the prudence requirement when plan fiduciaries select an annuity provider for benefit distributions from defined contribution plans, including participant-directed 401(k) plans. Though the regulation does not provide an explicit safe harbor for selecting GMWB providers, since the GMWB feature is different from a traditional annuity, the regulation nevertheless provides guidance as to the steps that fiduciaries should take to prudently select a GMWB provider, that is, an insurance company. As described below, the safe harbor regulation sets out five requirements that the fiduciaries must satisfy.

¹² ERISA Regulation § 2550.404a-4.

The fiduciaries must engage “in an objective, thorough and analytical search for the purpose of identifying and selecting providers.”¹³ As noted earlier, this is the same standard that applies to any fiduciary decision. Even without using the safe harbor as guidance, as an initial step it makes sense for the fiduciaries to gather information regarding GMWBs and competing providers. While GMWBs are relatively new, there are multiple providers offering similar products.¹⁴ Gathering information about the competing providers gives fiduciaries a starting point to consider their options. This will help fiduciaries compare the pricing, features, financial stability, administrative capabilities, and overall benefit of the competing providers and products.

The fiduciaries must consider information to assess the ability of the provider to make future payments under the contract.¹⁵ In the proposed regulation on the annuity selection safe harbor, the DOL laid out a number of factors that fiduciaries should consider;¹⁶ and while some of this detail was not included in the final regulation¹⁷, the factors are instructive to fiduciaries attempting to evaluate providers of GMWBs. The items identified by the DOL were the following¹⁸:

- The insurance company’s level of experience and financial expertise in providing guaranties of the type being selected;
- The insurance company’s level of capital, surplus and reserves available to make payments under the GMWB;
- The insurance company’s ratings by insurance rating services (reference to ratings by appropriate rating agencies is retained in the final regulation¹⁹);
- The structure of the contract; and
- The availability and extent of additional protection through state guaranty associates.

The fiduciaries must conclude, at the time they are making the decision that the information that is reviewed is supportive of a conclusion that the insurance company is financially able to make future payments under the contract and that the cost of the contract is reasonable in relation to the benefits and services to be provided under the

¹³ ERISA Regulation § 2550.404a-4(b)(1).

¹⁴ Information regarding different types of insured retirement income products can be found on the IRIC website at www.iricouncil.org

¹⁵ ERISA Regulation § 2550.404a-4(b)(2).

¹⁶ Proposed Regulation §2550.404a-4, 72 Fed Reg. 52021 (September 12, 2007).

¹⁷ See Preamble to ERISA Regulation §2550.404a-4, 73 Fed. Reg. at 58448.

¹⁸ Proposed Regulation §2550.404a-4(c)(2)(iii), (iv), (v), (vi) and (vii), 27 Fed. Reg. at 52024-5.

¹⁹ 73 Fed Reg. 58448 (Preamble to ERISA Regulation § 2550.404a-4)

contract.²⁰ (Keep in mind that the initial payments, and in many cases all of the payments, are made from the participant's investments. The guarantee is only for those participants whose investments are ultimately depleted, and then only for the guaranteed amounts, *e.g.*, 5% per year of the benefit base.) The fiduciaries may reach their conclusion when the provider is selected – based on information available at that time – though they will still need to periodically review (or monitor) the appropriateness of the conclusion as facts and circumstances change.²¹ Arguably, the analysis should be whether there is any information the fiduciaries know or should know that would suggest the GMWB provider will not be able to make payments in the future.

If necessary, the fiduciaries could consult with an appropriate expert. The DOL makes it clear that engaging an expert is not required.²² Rather, the fiduciaries must decide whether and to what extent they need assistance in considering and evaluating the GMWB providers. While seeking advice from a consultant should help demonstrate prudence when selecting a GMWB provider, it is not a complete absolution of fiduciary duties. The fiduciaries must still review and consider the expert's recommendations.

The prudence standard sets a high bar, but it does not require fiduciaries to predict the future.²³ Rather, the law requires that fiduciaries engage in a careful and thoughtful process to consider the relevant information and make an informed decision based on that information. Though the safe harbor selection process for annuities does not apply to GMWBs, if fiduciaries follow an equivalent process in selecting a GMWB provider, they should have a high degree of confidence they have satisfied their fiduciary duties.

Conclusion

Guaranteed retirement income solutions provide potentially valuable benefits for 401(k) plan participants, and GMWBs are an innovative response to concerns about traditional annuity-type approaches. By guaranteeing a benefit base, GMWBs provide protection against investment losses and a safety net of a guaranteed distribution in case the participant's own retirement funds are depleted. Nevertheless, as with any investment or product offered to plan participants, fiduciaries must be careful to engage in a prudent, thoughtful process of gathering relevant information, assessing that information and making an informed, reasoned decision both about *whether* to offer GMWBs to their participants and about *which* of the GMWB products on the market to offer.

²⁰ ERISA Regulation § 2550.404a-4(b)(4).

²¹ ERISA Regulation § 2550.404a-4(c).

²² ERISA Regulation § 2550.404a-4(b)(5).

²³ See *Bunch v. W.R. Grace & Co.*, 555 F.3d 1, 7 (1st Cir. 2009).



About the Authors

Fred Reish is a member of The Institutional Retirement Income Council (IRIC) and is an ERISA attorney whose practice focuses on fiduciary responsibility and plan operational issues. His clients include plan sponsors and fiduciaries, broker-dealers and RIAs, recordkeepers and TPAs and other financial service companies and providers. He was recognized as one of the 15 “Legends” of the retirement industry by plansponsor magazine. Fred also received awards for: the 401(k) Industry’s Most Influential Person by 401kWire; the Commissioner’s Award and the District Director’s Award by the IRS; the Eidson Founder’s Award by ASPPA; the Institutional Investor and the plansponsor magazine Lifetime Achievement Awards; and the ASPPA 401(k) Leadership Award. In addition, he has been recognized in the legal community as a Charter Fellow of the Employee Benefits Counsel of the American Bar Association and as one of “The Best Lawyers in America.” He has written 350 articles and four books about retirement plans, including a monthly column on 401(k) fiduciary issues for plansponsor magazine. Fred Co-Chaired the IRS Los Angeles Benefits Conference for over 10 years, served as a founding Co-Chair of the ASPPA 401(k) Summit, and has served on the Steering Committee for the DOL National Conference.

Bruce Ashton is a partner of the law firm of Reish & Reicher, specializing in employee benefits. His practice today focuses on all aspects of employee benefits issues, including representing public and private sector plans and their sponsors, negotiating the resolution of plan qualification issues under EP Division remedial correction programs, advising and defending fiduciaries on their obligations and liabilities, and structuring qualified plans, non-qualified deferred compensation arrangements and health care arrangements. Combining his employee benefits and transactional expertise, Bruce is also active in the installation and funding of employee stock ownership plans (ESOPs). Bruce served as President of the American Society of Pension Professionals and Actuaries (ASPPA) for the 2003-2004 term. From 1998 through 2002, he served as the co-chair of ASPPA's Government Affairs Committee and has been a member of its board of directors since 1997. He was a member of the Board of Directors of the American Academy of Actuaries during 2003-2004 and was the president of the Western Pension & Benefits Conference Los Angeles Chapter from 2008-2009. Bruce has been recognized as one of "The Best Lawyers in America" and as a "Super Lawyer" in Southern California. He is listed in the California edition of Who's Who Legal and is recognized by 401kWire as one of the Most Influential People in the 401(k) Industry.