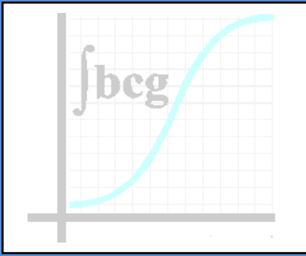

BCG Retirement News Roundup

April 2019 Volume 8, Issue 4

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Boomershine Consulting Group (BCG) provides this monthly news roundup of highlighted significant articles from the retirement industry – for clients and friends. Retirement plan news has become increasingly pertinent for many audiences these days, including:

- Retirement Plan Sponsors – addressing both private and public sector issues
- Employers – dealing with complicated decision making for their plans
- Employees – educating the Boomer generation that is nearing retirement
- Industry Practitioners - helping to understand and resolve today's significant challenges

We review numerous industry news services daily and will include a collection of timely and significant articles each month concerning compliance, actuarial plan costs (including assumption debates), plan design change issues and benefit trends, as well as other related topics. If you would like to discuss any of these issues, please contact us.

Inside This Issue

Public Sector/Government Plans

- Morgan Stanley to pay $130 million to California pensions over bad investments
- How One Small Pension Fund Added $1 Billion in Value
- The Long Bull Market Has Failed to Fix Public Pensions
- New Jersey to Require Certain Employers to Participate in a State "Auto-IRA" Retirement Savings Plan Program
- Rationality and Retirement: Mutually Exclusive?

Private Sector

- How the Target-Date Fund Landscape Is Evolving
- IRS Reopens Determination Letter Program for Two Significant Groups of Plans
- Your Retirement Plan – An Awesome Recruiting Tool . . . and an Awesome Responsibility
- T. Rowe Price: 401(K) Loan Usage Reaches Nine-Year Low
- Revenue Procedure 2019-19: Enhancements to EPCRS are Great News for Plan Sponsors

Public Sector/Government Plans

Morgan Stanley to pay $130 million to California pensions over bad investments

One of the world's largest investment banks has agreed to put $130 million into the nation's biggest public pension system to settle accusations it knowingly sold bad investments that caused the retirement fund for millions of workers to lose money.

California Atty. Gen. Xavier Becerra announced the settlement with Morgan Stanley on Thursday. The bank is to pay $150 million. Of that, $122 million will go to the California Public Employees' Retirement System, known as CalPERS, and $8 million will go to the California State Teachers' Retirement System, or CalSTRS. The rest will go to the attorney general's office.

Thursday's settlement is part of California's effort to recover the billions of dollars it lost during the financial crash of 2008, after banks rushed to approve mortgage loans in the mistaken belief the homes would not lose their value even if the buyers failed to pay the money back. But home values plummeted, leading to a worldwide financial crisis.
Including Thursday's settlement, Becerra said California has recovered $1.3 billion from banks and other financial institutions since 2008.

The settlement is a small one for Morgan Stanley, a company that earned $2.4 billion in profit from a total of $10.3 billion in revenue during the first three months of this year. But it is significant because it is the company's last settlement with government agencies related to the financial crisis. The bank agreed to pay the federal government $2.6 billion in 2016.
Becerra announced the settlement during a news conference in Los Angeles. From 2003-07, Morgan Stanley sold California's two largest pension systems bundles of thousands of mortgage loans. But according to Becerra, the financial giant did not adequately assess those loans to remove the risky ones and lied about it to the pension systems.
A Morgan Stanley spokesman declined to comment Thursday. But the company denied the allegations in a settlement agreement.
"They may tell you they didn't do anything wrong, but they gave us $150 million. You don't do that for free," Becerra said. "Whether or not someone admits it or not, this settlement involves a company that lied and misrepresented to investors what it was selling."
Becerra and his top deputies repeatedly said Morgan Stanley lied and engaged in fraud,

but no one at the company was charged with a crime. Becerra said the time limit authorities had to bring charges expired before they could gather enough evidence.
“We need better laws to make it more possible for us to go after the criminal conduct and not simply the civil miscarriage of justice. That is a big frustration,” Becerra said. “What you try to do is make those who violate the law pay a price for having done so.”
Becerra said the bad investments from Morgan Stanley cost the pension systems more than $100 million. Together, California’s two largest pension systems cover more than 2.5 million people. Their assets have a combined market value of more than half a trillion dollars. Still, the plan for state and local employees has only about 68% of the money it needs to pay benefits over the next few decades, while the plan for teachers has about 63% of the money it needs.
“Helping these funds recover their losses matters, because what it means is retirement security for a teacher, for a police officer, a firefighter: servants of our state,” Becerra said.

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How One Small Pension Fund Added $1 Billion in Value

The $10 billion San Bernardino County retirement fund claims it found an “incredible source of alpha.”

In 2006, the San Bernardino County Employees’ Retirement Association made a decision that it credits with adding nearly $1 billion to its portfolio over time.

The fund did not hire a particularly talented manager or bet big on a hot new asset, but rather improved its investment process — specifically, how its nearly $10 billion portfolio gets rebalanced.

Rebalancing is a necessary aspect of institutional investing, the means of ensuring the actual makeup of a portfolio matches its target allocation. But it can be costly: sell equities on a down day, and those losses are locked in.

Arun Muraldihar, whose firm AlphaEngine Global Investment Solutions advised SBCERA on its rebalancing revamp, explained the asset allocation problem by comparing it to a drunk driver swerving down the street with only the guard rails on either side of the road to keep them on course.

“When these funds approve an asset allocation — let’s say they approve a 60/40 portfolio — the board gives them permission to let it drift to 65 on the high end and 55

on the low end," he told Institutional Investor in an interview. "But just letting a portfolio drift between the guard rails is bad governance."

By adopting a more strategic method of rebalancing, Muralidhar said, allocators like the San Bernardino County pension can tap into what he described as an "incredible source of alpha."

Other institutions have gotten tactical with asset allocation, such as the Verizon Investment Management Company, the General Mills corporate pension fund, and the New Zealand Super Fund, Muralidhar said.

SBCERA's "informed rebalancing program" launched in 2006. Since then, the program has added an extra $965 million to the portfolio, or about 1.25 percent in additional returns annually, according to a case study by fund CIO Donald Pierce, Muralidhar, and AlphaEngine co-CIO Sanjay Muralidhar.

"Instead of letting a portfolio aimlessly drift until some happenstance trigger occurs, a clearly identified staff member was tasked with taking ownership of the asset allocation decision and making adjustments in an explicit, rules-based, and informed manner," they wrote.

The rules for portfolio rebalancing were based on peer-reviewed academic research, and focused primarily on asset valuations. Under this regime, decisions "were not arbitrarily triggered, but rather provided staff's best estimates of which assets were over/undervalued and in turn, over/underweighted within the board-approved ranges," according to the paper.

"In a way you're building a GPS for the portfolio," Muraldihar explained. "In this era where CIOs are struggling to meet their target returns, this is an untapped opportunity for CIOs who are willing to be innovative and creative enough."
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The Long Bull Market Has Failed to Fix Public Pensions

Sums owed to retirees are accelerating faster than assets on hand to pay those future obligations

Maine's public pension fund earned double-digit returns in six of the past nine years. Yet the Maine Public Employees Retirement System is still $2.9 billion short of what it needs to afford all future benefits to all retirees.

"If the market is doing better, where's the money?" said one of these retirees, former game warden Daniel Tourtelotte.

The same pressures Maine faces are plaguing public retirement systems around the country. The pressures are coming from a slate of problems, and the longest bull market in U.S. history has failed to solve many of them.

There is a simple reason why pensions are in such rough shape: The amount owed to retirees is accelerating faster than assets on hand to pay those future obligations. Liabilities of major U.S. public pensions are up 64% since 2007 while assets are up 30%, according to the most recent data from Boston College's Center for Retirement Research.

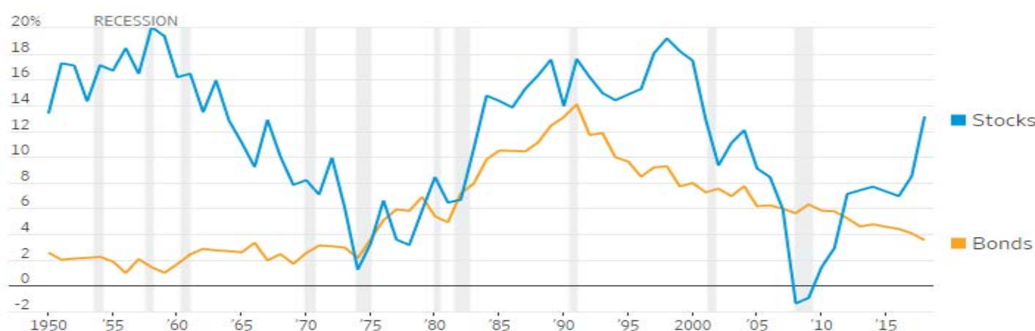
Here is how it got that way:

The Financial Crisis Happened

Public pension funds have to pay benefits—their liabilities. They hold assets, which grow or shrink through a combination of investment gains or losses and contributions from employers and workers. Those assets generally rose faster than liabilities for five decades starting in the 1950s because government was expanding and the number of retirees was smaller.

In the 1980s and 1990s, double-digit stock and bond returns convinced governments they could afford widespread benefit increases.

Ten-year returns on core pension fund investments

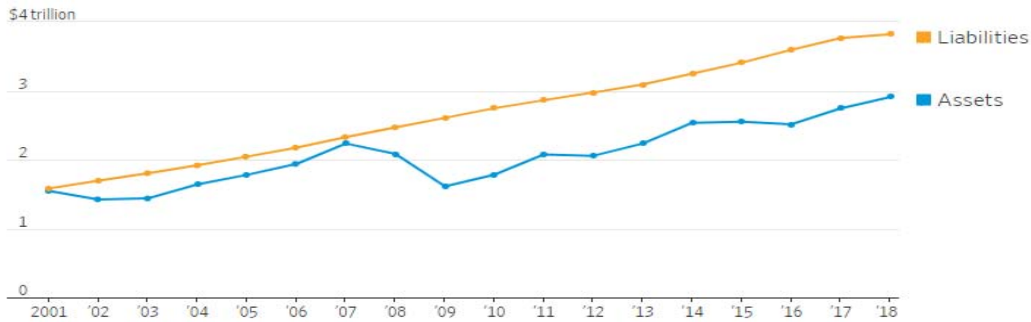


Sources: S&P 500 Index, Lehman Aggregate Bond Index, Barclay's Capital Aggregate Bond Index, Bloomberg Barclays US Aggregate Bond Index. Data compiled by Cheiron.

But the value of their holdings—their assets—began to fall in the aftermath of the dot-

com bust in the 2000s, and the 2008 financial crisis followed soon after. State and local retirement systems lost 28% in 2008 and 2009, according to the Boston College data.

Liabilities and assets for major U.S. public pensions



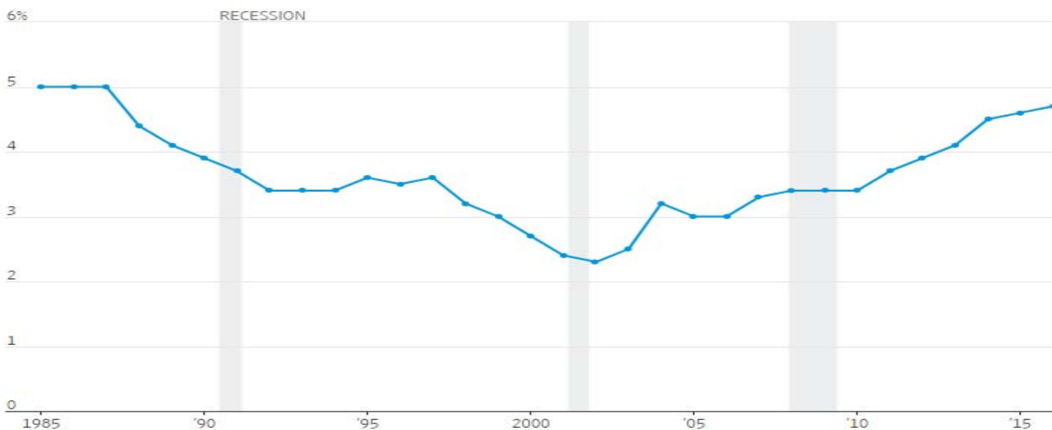
Note: Data cover 109 major pensions for which 2018 data is available.
Source: Boston College Center for Retirement Research

“The first thing you have to do is make up what you lost,” said Sandy Matheson, executive director of the Maine Public Employees Retirement System. “And it takes years. And then you have to make up what you didn't earn on what you didn't have. It's a pretty steep climb.”

Governments Fell Behind on Their Payments

Cities and states set out to ramp up their yearly contributions to public pension funds as a way of making up for their investment losses.

Percentage of all state- and local-government spending on public pensions



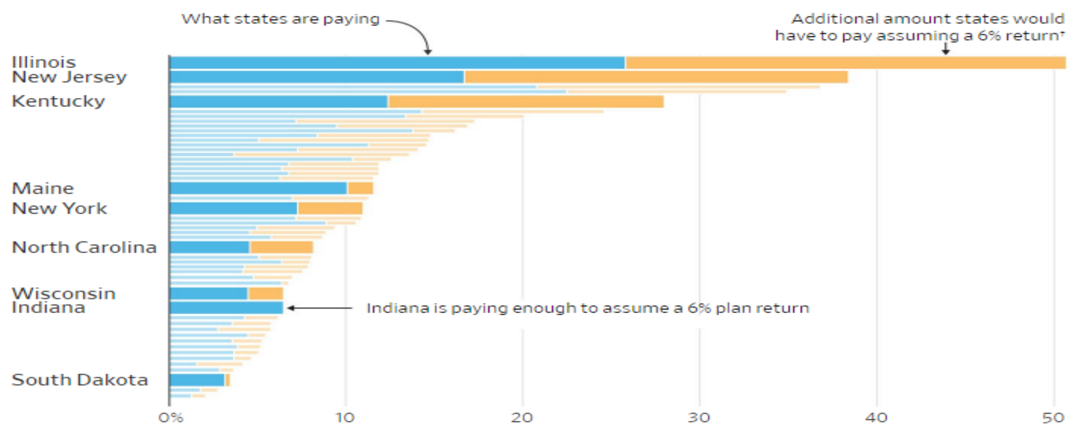
Source: National Association of State Retirement Administrators

Source: National Association of State Retirement Administrators

Some were able to keep up with those payments. But others weren't as they struggled with lower tax revenue and increased demand for government services in the aftermath of the 2008 crisis. New Jersey made less than 15% of its recommended pension payment from 2009 through 2012. It now has a little more than one-third of the cash it needs to pay future benefits—despite robust investment returns in recent years.

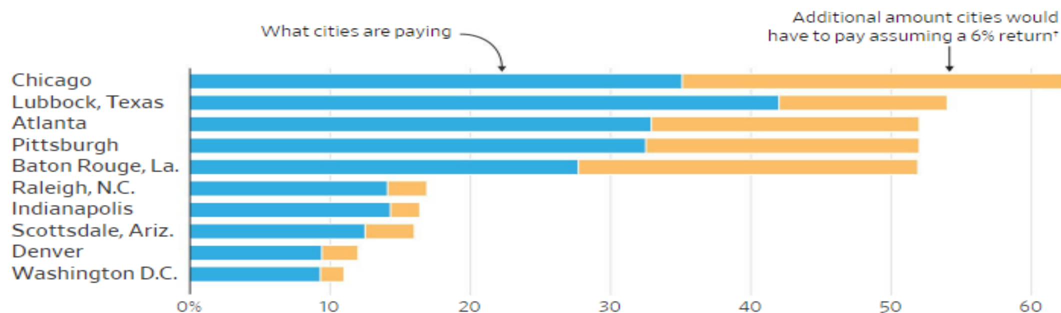
State Treasurer Elizabeth Maher Muoio said New Jersey is on "the long road to addressing our unfunded liability after years of neglect."

Pensions and other long-term costs as a percentage of 2017 state revenues



"Some of the states allowed themselves to get so underfunded that the higher returns aren't helping them enough," said Michael Cembalest, chairman of market and investment strategy for the asset-management arm of JPMorgan Chase & Co. and the author of an annual study on the financial health of cities and states.

Pensions and other long-term costs as a percentage of 2016 city revenues



Some states, including New York, Wisconsin, Tennessee and South Dakota managed to keep assets roughly in line with liabilities through funding discipline, benefit cuts, or both.

Deeper Pension Cuts Didn't Materialize

Many states and cities reduced benefits for new employees after 2008. But deeper cuts often met resistance from judges, unions and angry constituents—even in some of the most indebted states.

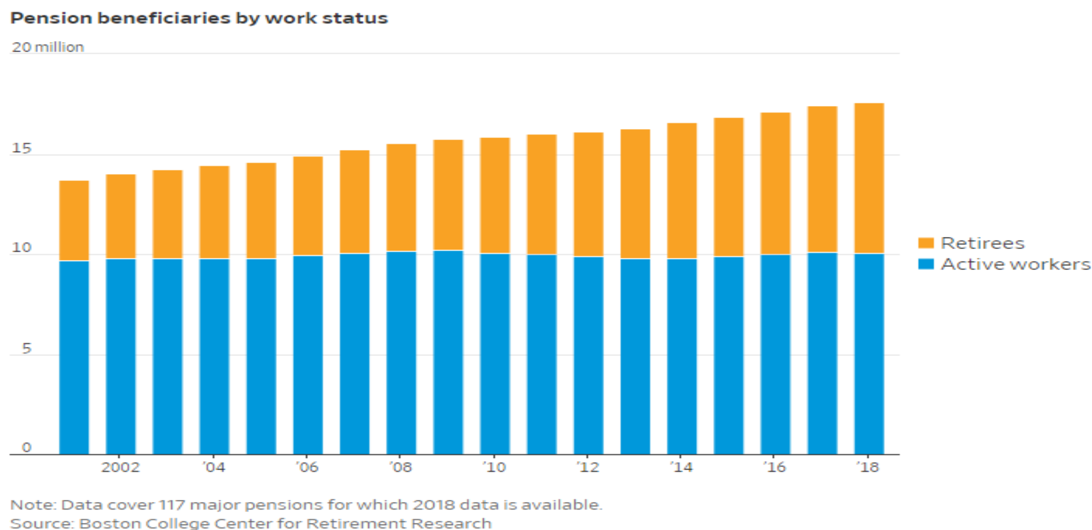
The Illinois Supreme Court in 2015 threw out cuts by the legislature that were expected to save tens of billions of dollars. Kentucky's legislature last year declined to approve the governor's proposed cuts to cost-of-living increases for retired teachers after protests brought thousands to the state capitol and forced cancellations of classes in several school districts.

Maine, which has made more progress than many plans in addressing its unfunded liability, did cut cost-of-living increases for both retired and active state workers. They earn a median pension of $27,000 after 25 or more years' service and don't receive Social Security. But that cut shaved only $1.6 billion off the fund's unfunded liability, which now stands at $2.9 billion.

People Got Older

Demographics became another problem as baby boomers aged. The number of pensioners jumped thanks to longer lifespans and a wave of retirees over the past decade, while the number of active workers remained relatively stable.

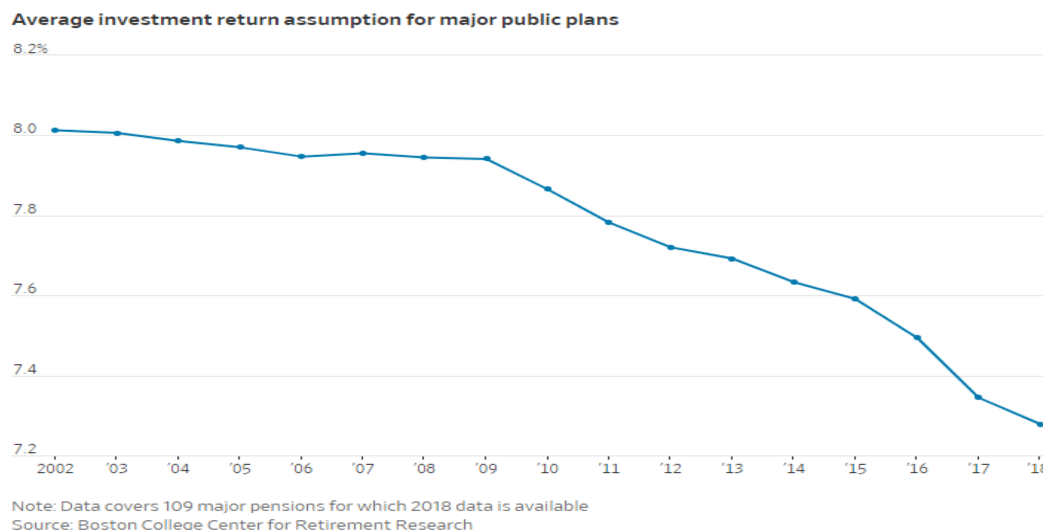
Maine's fund serves about the same number of active workers that it did in 2008—a little more than 51,000—while the number of retirees has jumped 32% to about 45,000. Many funds are experiencing the same trend.



That pattern contributes to an increasing gap between pension fund inflows and outflows—before the funds earn a dollar on investments. Maine's pension fund paid $982 million in benefits in 2018, $394 million more than the contributions it took in. For a plan trying to improve its funding status, that type of gap makes it harder to recover from investment losses.

The Future Looks Worse

Many public pension funds have benefited from the 10-year-long bull market. But now many are lowering their predictions of what they can earn in the future. That accounting change makes their liabilities look even larger, portending more strain in the coming decades.



The Maine pension fund, which back in the early 1980s assumed a long-term investment return of 10%, now assumes a rate of 6.75%. If that rate were just 1 percentage point higher—where it was about 10 years ago—the projected $2.9 billion shortfall, most of which must be paid off over the next decade, would drop by more than half to $1.1 billion.
The decision to lower the rate was based on discussions with the fund's actuarial and investment consultants and a goal of keeping costs predictable, said Ms. Matheson, the system's executive director. "There's also an element of better safe than sorry."

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New Jersey to Require Certain Employers to Participate in a State "Auto-IRA" Retirement Savings Plan Program

On March 28, 2019, New Jersey became the sixth state to pass legislation requiring that certain employers offer to employees a state-sponsored individual retirement account ("IRA") program with automatic enrollment and pre-tax payroll deduction contributions (the "NJ Auto-IRA Law"). "By creating the Secure Choice Savings Program, we are ensuring that every worker in New Jersey will have the opportunity to save for the future," New Jersey Governor Phil Murphy stated when he signed the program into law.

New Jersey joins California, Connecticut, Illinois, Maryland, and Oregon in offering auto-IRA

programs. Other states, including Washington, are considering offering similar programs.
Who Is Subject to the NJ Auto-IRA Law?

Employers will be subject to the NJ Auto-IRA Law and required to automatically enroll their employees in the New Jersey Secure Choice Savings Program (the "Program") if they:

- Employed no fewer than 25 employees at all times in New Jersey in the prior year;
- Have been in business for at least two years; and
- Have not offered a qualified retirement plan (e.g., a 401(k) plan or 403(b) plan or a plan sponsored by an employee leasing company or professional employer organization that the employer has used in the preceding two years).

Employers subject to the NJ Auto-IRA Law include for-profit and non-profit employers, but do not include any governmental employers in New Jersey.

What Is the Deadline to Comply with the NJ Auto-IRA Law?

Implementation of the Program and the beginning of employee enrollment are to occur by March 28, 2021, which is 24 months after the effective date of the NJ Auto-IRA Law. However, the NJ Auto-IRA Law allows the New Jersey Secure Choice Savings Board (the "Board"), which will administer the Program, to extend the time period for implementation by up to 12 months.

What Will Employers Need to Do to Comply with the NJ Auto-IRA Law?

Distribute an Information Packet on the Program, Prepared by the Board

For the first six months following the opening of the Program, the Board will provide a process by which employers may register for the Program. Participating employers will be required to distribute an employee information packet prepared by the Board to (1) existing employees, upon the implementation of the Program, and (2) new employees, at the time of hire.

Set Up a Payroll Deposit Retirement Savings Arrangement for Automatic Enrollment

Employers subject to the NJ Auto-IRA Law must set up a payroll deposit retirement savings arrangement no more than nine months after the Board opens the Program for enrollment, and automatically enroll any employees who have not opted out of the Program.

Deposit Employee Payroll Deductions into the Program Fund

Participating employers must deposit employee payroll deductions into the New Jersey Secure Choice Savings Program Fund (the “Program Fund”).

Offer an Annual Open Enrollment Period Following Initial Implementation of the Program
Following the initial implementation of the Program, participating employers must offer an open enrollment period, at least once every year, to allow employees who originally opted out of the Program to enroll.

Enroll a New Employee No Later Than Three Months Following the Date of Hire

No later than three months following the date of hire, employers must also enroll an employee hired more than six months after the Board opens the Program for enrollment, unless that employee opts out of the Program prior to automatic enrollment.

What Penalties Apply for Noncompliance with the NJ Auto-IRA Law?

The NJ Auto-IRA Law imposes various penalties—ranging from a warning to a $500 per employee fine—upon employers for failing to timely enroll employees in the Program. The potential penalties will increase over the course of the Program’s implementation and over multiple violations.

Employers that collect employee contributions but fail to deposit any portion of the contributions to the Program Fund will be subject to (1) a penalty of $2,500 for a first offense and (2) a penalty of $5,000 for the second and each subsequent offense.

What New Jersey Employers Should Do Now

Given that the implementation of the Program and the beginning of employee enrollment in the Program are to occur by March 28, 2021, New Jersey employers that will be subject to the NJ Auto-IRA Law do not need to take action for compliance at this time. However, these employers may want to do the following now:

- Consider whether to establish a qualified retirement plan instead of having to comply with the NJ Auto-IRA Law (assuming it is not preempted by federal law[1]); and
- Continue to monitor the New Jersey Department of Treasury’s website for further guidance on compliance with the NJ Auto-IRA Law.

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Rationality and Retirement: Mutually Exclusive?

No one lives forever. So why, 18 years into retirement, have individuals generally spent only 20% of their nest egg? Why, if people want to conserve their assets, do nearly half of Americans take Social Security benefits at the earliest possible age of 62 – receiving only about 70% of the full benefit available at age 67?[1]

Money and rationality don't always mix, of course. That's especially true with retirement. The issue is complex and uncertain and can trigger feelings of fear and anxiety that may interfere with rational decision-making.

One way to address these issues is for the industry – consultants, advisors, plan sponsors and asset managers – to apply insights from behavioral finance. We believe this could encourage smarter, more rational decisions as people enter retirement.

Indeed, behavioral insights have played an important role in helping people save for retirement. Automatic enrollment into company-sponsored retirement accounts and default investments such as target-date funds have jump-started asset accumulation and prompted use of more-disciplined investment strategies. These "nudges" transform a cognitive bias – inertia – from a negative to positive.

However, nudging individuals to make more rational decisions as they enter retirement will be more challenging. The decisions that one needs to make at or near retirement, which significantly affect one's ability to enjoy the "golden years," are arguably more complex than those made during the accumulation phase. Not only are these decisions complex in isolation, but the complexity is amplified because each decision is interrelated to all of the others, as we outlined in recent research. Indeed, key questions – such as when to take Social Security, how to invest assets, whether to buy an annuity and how quickly to spend savings over an unknown remaining lifetime – can befuddle the most sophisticated minds in finance, let alone individuals with modest savings and limited financial knowledge.

Here are four decisions where insights from behavioral finance may promote more rational decisions and help to improve retirement security for millions of Americans:

1) SOCIAL SECURITY

Our research indicates that individuals with average health and moderate affluence would likely be better off deferring Social Security benefits until age 70.

Nonetheless, about 90% of those eligible claim Social Security before the full benefit age of 67. Without doubt, there are rational reasons to take Social Security early – including poor health, limited financial resources, spousal considerations and concern over the survival of Social Security. Yet it is clear that the vast majority of individuals are not optimizing this decision. This mass early election may partially be explained by the “present-bias” – the human preference to take an immediate reward over a future one.

Academic research suggests that modifying this behavior may be difficult at best. Nonetheless, solutions may include improved financial literacy and improved communication around the consequences of early election, especially if it intensifies the very powerful human emotion, regret.

2) ANNUITIES

One of the greatest complexities with retirement planning lies in not knowing how long you will live and therefore how long your assets will need to last. Certain types of annuities, such as deferred annuities, seek to address the risk of outliving one’s assets, commonly known as longevity risk, and therefore greatly simplify the retirement planning problem. Deferred annuities provide guaranteed income for life and commence their payout at a future time. For instance, a retiree at 65 years of age who purchases a deferred annuity with payments beginning at 85 may have greater confidence in consuming a portion of their nest egg.
So why do so few individuals buy annuities? For most defined contribution participants, annuities are simply not made available. And even when available, few buy them, finding annuities expensive and complicated.

Moreover, behavioral science suggests that emotion also may play an important role. Specifically, the best predictor of whether someone will consider an annuity is sensitivity to issues of fairness, according to research by Suzanne Shu, Robert Zeithammer and John Payne – in particular, the belief that the insurance company will keep excess funds when the policyholder dies.

The old adage that annuities are sold, not bought, suggests that personalized education and advice will be required to overcome cognitive biases against annuities.[2]

Of course, it is unlikely that the rate of annuity adoption will change any time soon. Therefore, in order to simulate the relative stability that some types of annuities provide and hedge longevity risk, one must assume a more conservative asset allocation, favoring fixed income over equities.

3) ASSET ALLOCATION

Prospective retirees must determine how to invest their savings between stocks and bonds. A

key assumption in our modeling is that individuals strive for a stable retirement income stream. Holding more in equities may generate higher retirement income and allow for a higher quality of life, but it comes with greater uncertainty. Conversely, holding more in bonds may increase the certainty of income but likely at a lower level.

Our research finds that those with more wealth should hold less equity exposure than those with less wealth. This is not because of growing risk aversion as one ages. Rather, it's because as wealth grows, Social Security – which mimics the role of bonds in providing an income stream – represents a shrinking percentage of total income. It follows that wealthier people need to replace that missing fixed income exposure with bonds within their financial portfolio. Therefore, Social Security may be one of the most important factors driving the asset allocation decision.

Empirical data, however, show that few individuals de-risk their portfolios. Whether viewed through the lens of age or wealth, data suggest that most individuals simply hold portfolios with approximately 60% equities and 40% bonds.

4) CONSUMPTION RATES

What is a reasonable level of principal drawdown for a retiree? Too aggressive a pace may deplete assets and impair the retiree's lifestyle. Conversely, if one spends too little, their quality of life may suffer unnecessarily. Complicating this question is PIMCO's belief that returns from equities and bonds will be lower going forward than in recent decades
With the goal of maximizing high quality, stable income in retirement, according to our framework, most individuals can afford to consume roughly 3.5%–5.0% of their savings every year, adjusting for inflation, depending largely upon one's willingness to consume from both portfolio returns and principal as well as address longevity risk. If one is willing to allocate a significant portion of their assets to address longevity risk in the form of a deferred annuity, consumption at the higher end of the range can be justified.

Interestingly, regardless of one's wealth level at retirement, most retirees prefer to consume only income derived from Social Security, their pension or investment portfolio, but not principal. After 18 years, the typical retiree has used only 20% of their assets.[3]

These reasons are far from irrational, of course. The aversion to consuming principal is strong and may reflect one's desire to self-insure against future expenses, medical concerns, longevity risk and, for a limited few, a wish to pass wealth to heirs.

Clearly, the human preference to spend income and preserve principal should be incorporated into retirement income portfolio design to help overcome this mental accounting bias. Specifically, portfolios favoring returns sourced from income over capital gains may create

more stable portfolios, and stimulate greater consumption in retirement commensurate with one's means.

Conclusion

Making optimal decisions for retirement is inherently difficult. Human emotion and cognitive bias lead many of us to make suboptimal judgments. It's time for the industry to make better use of behavioral science to nudge retirees toward improved decisions and retirement outcomes.

[1] 67 is the full Social Security retirement age for people born in 1960 and later.
[2] Some deferred annuity contracts may pay a death benefit to beneficiaries if the policyholder dies before income payments.
[3] See ebri.org.

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Private Sector

How the Target-Date Fund Landscape Is Evolving

5 takeaways from Morningstar's latest report on target-date strategies

Target-date strategies saw another year of strong flows from investors, lifting assets in target-date mutual funds and target-date collective investment trusts to more than $1.7 trillion at year-end 2018.

Target-date strategies often serve as the default investment option in many Americans' defined-contribution retirement plans. The persistent growth and massive amount of assets mean that target-date strategies are playing a key role in helping meet the retirement goals of more and more investors.

In our latest report, we cover how investor demand for target-date strategies is evolving and how target-date providers have responded.

5 takeaways from Morningstar's 2019 Target-Date Fund Landscape report

1. Price is driving popularity. Of the estimated net $55 billion investors placed in target-date mutual funds in 2018, $57 billion went to funds with expense ratios less than or equal to 0.20%. Meanwhile, funds with expense ratios higher than 0.60% saw approximately $37 billion leave during the year.

2. Target-date providers are responding to the demand for lower-cost options. In recent years, many providers have cut costs, launched cheaper alternatives, and made their strategies available in lower-cost vehicles like CITs. Eight of the 10 largest target-date providers by total target-date assets offered their strategy through both mutual fund and CIT vehicles at year-end 2018.

3. Target-date funds that hold mostly index funds appear poised to take the lead. Target-date fund series that held more than 80% of assets in index funds captured nearly all of the $55 billion estimated net flow to target-date mutual funds in 2018. If recent trends hold, assets in series that invest predominantly in index funds (roughly $480 billion) could overtake series that hold mainly active funds (roughly $570 billion) within a couple of years.

4. Target-date CITs are thriving. Assets in target-date CITs grew by approximately $30 billion to over $660 billion in 2018 when assets in target-date mutual funds declined to $1.09 trillion from $1.11 trillion. Of the largest target-date providers, both Fidelity and T. Rowe Price saw positive net inflows to target-date CITs in 2018, while also experiencing net outflows from their target-date mutual funds.

5. Vanguard is dominating the market. The firm's roughly $650 billion in total target-date assets at year-end 2018 accounted for nearly 40% market share, dwarfing the 15% market share of its next-closest competitor. In addition to its market-leading $40 billion in estimated target-date fund net inflows in 2018, Vanguard also saw roughly $28 billion in CIT net inflows.

In addition to exploring key trends in the competitive landscape, this year's report highlights noteworthy considerations in five areas: Price, Performance, Parent, People, and Process. It also previews a few of the new data points and exhibits that will become fixtures of the enhanced Morningstar's Target-Date Fund Series Reports set to launch in June 2019.

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IRS Reopens Determination Letter Program for Two Significant Groups of Plans

In response to periodic requests to expand the determination letter program, the Internal Revenue Service ("IRS") has issued welcome guidance in Revenue Procedure 2019-20 (May 1, 2019). The guidance opens up the determination letter program for statutory hybrid plans (e.g., cash balance plans) and merged plans, and provides helpful relief from document failures identified and corrected as part of those determination letter applications, as discussed below.

KEY TAKEAWAYS FOR PLAN SPONSORS

Plan sponsors of cash balance and other defined benefit plans that use a statutory hybrid formula have a limited opportunity to submit the plan to the IRS for a determination letter from September 1, 2019 through August 31, 2020.

Starting September 1, 2019, plan sponsors of merged plans will be able to submit the merged plan for a determination letter application within a limited period after the corporate transaction and plan merger.

Background

In June 2016, the IRS announced that it was eliminating the long-standing five-year cycle determination letter program for individually designed tax-qualified retirement plans. [IRS Rev. Proc. 2016-37] At the time, the IRS said that it would continue to accept determination letter applications from individually designed plans only for the purposes of initial qualification, qualification at plan termination, and in other "specified circumstances" that the IRS may announce in subsequent guidance.

In April 2018, the IRS asked the public to submit comments on specific types of individually designed plans for which the IRS should consider reopening the determination letter program. [IRS Announcement 2018-24.] After considering the comments it received from the regulated community, including two comment letters filed by Groom Law Group on behalf of our plan sponsor clients, the IRS issued Revenue Procedure 2019-20. This latest Revenue Procedure represents the IRS' first foray back into the determination letter program for individually designed plans in "specified circumstances", as contemplated by Revenue Procedure 2016-37.

Limited Expansion Under Revenue Procedure 2019-20

Effective September 1, 2019, Revenue Procedure 2019-20 expands the determination letter program in two ways. First, sponsors of defined benefit plans that use a statutory hybrid formula (e.g., cash balance plans) will be eligible to apply for a new determination letter during a one-year period beginning September 1, 2019. Second, sponsors of "merged plans" (as defined below) will be eligible to apply for determination letters on an ongoing basis, but only during a limited period following the date of the corporate merger and plan merger.

A. Statutory Hybrid Plans

Any plan that uses a statutory hybrid formula is eligible to apply for a new determination letter between September 1, 2019 and August 31, 2020. For this purpose, a statutory hybrid formula means a lump-sum-based formula, or any formula that has a similar effect to a lump-sum-based formula. Common examples of statutory hybrid plan designs include cash balance plans, pension equity plans, and certain variable annuity plans. Under Revenue Procedure 2019-20, a plan that uses a statutory hybrid formula is eligible to apply for a determination

letter even if the plan also includes a "traditional" formula (e.g., benefits based on final average pay and credited years of service), and even if the plan's statutory hybrid formula was already in place when the plan received a prior determination letter.

Sanctions Relief: The IRS will not impose any sanctions for plan document failures relating to implementation of the final hybrid plan regulations that are discovered by the IRS in reviewing a determination letter application submitted pursuant to Rev. Proc. 2019-20. If the IRS discovers any other plan document failures, then as long as the amendment that created the failure was adopted timely and in good faith with the intent of maintaining the plan's qualified status (or the plan sponsor reasonably and in good faith determined that no amendment was required in connection with a change in qualification requirements), a reduced sanction equal to the applicable user fee under EPCRS will apply (e.g., the maximum user fee of $3,500 would apply if a large plan sponsor had self-reported the plan document failure by filing a VCP application). However, the IRS expressly states that the anti-cutback relief that expired before the 2017 plan year will not be extended for remedial amendments.

B. Merged Plans

Revenue Procedure 2019-20 also permits sponsors of merged plans to apply for a determination letter, starting September 1, 2019. For this purpose, a "merged plan" means a plan resulting from the merger or consolidation of two or more formerly separate plans into a single plan, which must have occurred in connection with a corporate merger, acquisition, or similar business transaction among unrelated entities. To be eligible, a plan merger must be completed within the required transition period under Code §410(b)(6)(C) (i.e., no later than the end of the plan year after the plan year that includes the date of the corporate transaction), and the determination letter application must be submitted by the last day of the first plan year (of the merged plan) that begins after the effective date of the plan merger.

For example, if a company acquires an unrelated entity in a corporate transaction as of July 1, 2019, and then merges the acquired company's plan into its plan as of January 1, 2020, then (assuming the merged plan uses a calendar year plan year) the deadline for submitting a determination letter application for the merged plan would be December 31, 2021. However, if the plan merger had been effective as of December 31, 2019 instead of January 1, 2020, the deadline for the merged plan's determination letter application would be December 31, 2020.

Sanctions Relief: The IRS will not impose any sanctions for plan document failures that relate to a plan provision included to effectuate the plan merger. If the IRS discovers any other plan

document failures in reviewing the merged plan's determination letter application, then as long as the amendment that created the failure was adopted timely and in good faith with the intent of maintaining the plan's qualified status (or the plan sponsor reasonably and in good faith determined that no amendment was required in connection with a change in qualification requirements), a reduced sanction equal to the applicable user fee under EPCRS will apply (e.g., the maximum user fee of $3,500 would apply if a large plan sponsor had self-reported the plan document failure by filing a VCP application).

Considerations for Plan Sponsors

The expansion of the determination letter program allows a plan sponsor some opportunities to have its plans reviewed by the IRS:

For sponsors of individually designed cash balance and other statutory hybrid plans, Revenue Procedure 2019-20 provides an important but time-limited opportunity to confirm whether their plan documents are fully compliant with the final cash balance regulations, including the IRS' requirements for using a "market rate of return" for a plan's interest crediting rate. The review will also consider any design changes or other programs (e.g., lump sum windows).

Sponsors of traditional defined benefit plans that may be considering converting to a cash balance or other hybrid formula should consider whether it may make sense to effectuate the conversion on or before August 31, 2020, in order to take advantage of this limited opportunity from the IRS.

Sponsors of plans that merge in connection with a corporate merger, acquisition, or similar transaction can seek a determination review on the merger. This review can be especially helpful in protecting merged plans from inadvertently failing to address any required benefits, rights, and features under the plans that are being merged. Note that this opportunity would apply to 2017 or 2018 corporate transactions where the merger occurred in 2018, as long as the filing is made by December 31, 2019 (for calendar year plans).

A merged plan that goes in for a determination letter can also have recent plan design changes reviewed as part of the application. This allows plan sponsors an opportunity to leverage off of M&A activity to periodically refresh a plan's determination letter, or have recent plan design changes reviewed by the IRS.

While these opportunities are very helpful, most qualified plans – such as 401(k) plans that have not been involved in a merger – will not be able to take advantage of them. These plan

sponsors should consider obtaining a law firm opinion letter, which Groom offers as part of its Document Compliance Service, to confirm their plan's tax-qualified status.

If you have questions on the expansion of the determination letter program, or need assistance with preparing a determination letter application, please reach out to your regular Groom attorney.

IRS Reopens Determination Letter Program for Two Significant Groups of Plans

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Your Retirement Plan – An Awesome Recruiting Tool . . . and an Awesome Responsibility

What do you think of when you hear the words precision, tolerances and quality control? Of course, these are words that describe how manufacturers conduct business on a daily basis – with an eye toward manufacturing a product that is to specifications and of the highest quality.

With a tight labor market and recent trends surrounding retirement concerns, offering a high-quality 401(k) plan is an essential recruiting and retention tool. Four of five employees indicate they want benefits and perks more than a pay raise, and a 401(k) ranks in the top five requested benefits, according to a recent Glassdoor survey. Millennials seem especially appreciative of benefits; 90% of employees 18 to 34 years old say they would prefer benefits over pay.

When it comes to small businesses (2-99 employees) only 42% offer retirement benefits. Yet, when searching for highly qualified employees, the smaller employer lacking an attractive 401(k) plan is in a less competitive position. Many smaller employers avoid the entire 401(k) issue due to fears and concerns about cost. Yet offering employees a plan can actually give you a unique competitive advantage. Top candidates will have multiple offers with fairly equivalent salaries. A top-notch 401(k) benefit can be a tie-breaker and will covey a strong company culture based on taking care of its employees.

Offering retirement plans can also be an important factor in reducing turnover. Employees who are making an investment in their future through retirement plans may be less likely to move on to other companies, in particular, when employers make matching contributions – a

key component of the employee's total compensation package

The quality of your 401(k) offering is essential. It is important to have the highest quality best practices when it comes to fiduciary governance, record-keeping, compliance, administration, investments, participant education, and reasonable fees and expenses. It is also important to understand the fiduciary responsibilities and oversight that is required to follow best practices.

Fiduciary responsibilities

Fiduciary liability, as defined by ERISA, can create both corporate and personal liability for the decisions you make regarding your 401(k) plan. This is where it is wise to take the same concepts you apply to manufacturing – precision, tolerances and quality control – when thinking about your responsibilities as plan sponsor of your company's 401(k) retirement plan. If your duties cause you to exercise discretion over plan assets or administration (hiring service providers, making investment choices, spending plan assets, etc.) you are a fiduciary and need to make sure you understand and comply with your duties. Fiduciary status is based on the functions performed for the plan, not a title. Be aware that hiring someone to perform fiduciary functions is itself a fiduciary act.

The Internal Revenue Service (IRS) defines a fiduciary's responsibilities as:

- acting solely in the interest of the participants and their beneficiaries;
- acting for the exclusive purpose of providing benefits to workers participating in the plan and their beneficiaries, and defraying reasonable expenses of the plan;
- carrying out duties with the care, skill, prudence and diligence of a prudent person familiar with the matters;
- following the plan documents; and
- diversifying plan investments.

In operational terms, at a minimum, the duties generally include overseeing investments and service providers, conducting educational efforts to help employees understand the plan and their options, administrative functions required for plan compliance, periodic review of plan documents, and documentation of your fiduciary process.

Some challenges are worth the effort

Sponsoring a retirement plan goes a long way toward putting employees in the best position to retire at a standard of living comparable to their working years. Employers benefit, as well. Retirement plans increase employee loyalty, thus reducing recruiting and retraining dollars.

Highly skilled and motivated employees result in greater productivity, innovation and profits. Human resources professional and consultant, Susan Heathfield, posited that benefits can add up to 7.3% bottom-line profit to a company.

Managing the risks associated with sponsoring a plan and maintaining plan compliance with complex IRS and Department of Labor (DOL) regulations can be challenging. Establishing a governance process can help you create clarity regarding the roles and responsibilities of plan fiduciaries.

As a plan sponsor and fiduciary, if you are unable to perform your necessary duties, it is incumbent upon the sponsor to obtain qualified help. For example, the selection, monitoring and replacement of 401(k) investments is a fiduciary decision. Engaging a qualified and properly licensed fiduciary advisor to assist or take over that responsibility is considered a best practice. Benchmarking your 401(k) plan fees, expenses and services is required to make sure your participants are paying reasonable costs. Again, an experienced advisor can help “peel the onion” and negotiate those fees and expenses on behalf of the plan sponsor and participants.

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T. Rowe Price: 401(K) Loan Usage Reaches Nine-Year Low

The use of 401(k) loans reached a nine-year low of 22.5% in 2018, and continued a steady six-year decline of nearly 10%, according to T. Rowe Price’s annual participant data benchmarking report, Reference Point. The report also found that the percentage of participants who took a hardship withdrawal fell for the ninth consecutive year, declining from 1.9% in 2010 to 1.3% in 2018. Meanwhile, both loan balances and the average amount of hardship withdrawals increased.

“Overall, we’ve seen an increase in positive participant behavior; however, there are still opportunities for continued improvement,” said Kevin Collins, head of Retirement Plan Services at T. Rowe Price. “Changing employee behavior requires simple solutions and engaging them in a way that motivates them to act. Plan sponsors can provide this support through plan design and by integrating financial wellness programs into their plan offering. We’ve seen firsthand the positive impact that approachable and easy-to-use resources have on employee behavior.”

ADDITIONAL KEY FINDINGS:

Participation declined slightly. The participation rate dropped by nearly 2% from 2017 to 2018.

Plans that did not have auto-enrollment saw participation drop at more than twice the rate of those without auto-enrollment.

Auto-enrollment continued to significantly impact positive participant behavior. Participation was over 40 percentage points higher in plans with auto-enrollment compared with plans without it.

Pretax deferral rates continued to rise. The average pretax deferral rate increased slightly to 8.6%, reaching the all-time high for a second year in a row.

Employer match increased. Plans offering a 4% employer match surpassed those offering a 3% match for the first time. The reduction of the corporate tax rate due to tax reform may have contributed to the increase.

Plan adoption and participant usage of target date products reached an all-time high. Plan adoption of target date products reached an all-time high at 95%. Participant usage also increased in 2018 across all age groups but was highest among younger workers. Additionally, the percentage of participants with their entire account balance in a target date product has grown by 20% since 2014.

401(k) Roth contributions increased. The number of participants making Roth contributions increased by nearly 10% compared with 2017; however, overall usage remains low at 7.6%. Millennials age 30–39 are using Roth the most, at nearly 10%, with younger workers age 20–29 following at 8.8%. In 2018, nearly 75% of plans offered the Roth option.

"We are dedicated to helping advisors and plan sponsors design plans and implement strategies that are beneficial for all participants," said Collins. "The overall progress we've seen in participant behavior is a testament to the commitment plan sponsors have to their employees' retirement success."

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Revenue Procedure 2019-19: Enhancements to EPCRS are Great News for Plan Sponsors

Newly published Revenue Procedure 2019-19 modifies and supersedes prior IRS guidance regarding the Employee Plans Compliance Resolution System (EPCRS) to allow plan sponsors to self-correct an expanded number of problems that may affect retirement plan operations or documents. The new guidance, which took effect April 19, 2019, provides a significant opportunity for plan sponsors to correct loan defaults and other minor operational failures

without going through the expensive and often time consuming voluntary correction program (VCP) procedure.

Prior to Revenue Procedure 2019-19, plan sponsors were required to file a VCP application seeking IRS approval of a retroactive amendment unless the sponsor was amending the plan solely to allow for hardship distributions or loans. Under the new guidance, a plan sponsor may correct an operational failure by retroactive plan amendment without submitting a VCP application if three conditions are satisfied:

(1) the amendment results in an increase of a benefit, right, or feature (such as the rate of matching contributions);

(2) the increase is available to all eligible employees; and

(3) the increase otherwise satisfies the general correction principles in the Revenue Procedure.

The Revenue Procedure also allows plan sponsors to correct certain plan document failures (such as the failure to timely correct a disqualifying provision) without filing a VCP application. The expanded self-correction method is available if:

(1) the plan has received a favorable determination or opinion letter;

(2) the error is not the failure to timely adopt a qualified plan or a written 403(b) plan document; and

(3) the correction occurs by the end of the second plan year following the year in which the plan document failure occurred (the self-correction period).

Perhaps most helpful to a large number of employers, the new guidance expands the scope of loan failures that can be self-corrected. First, plan sponsors may now report a deemed distribution in the year of correction rather than in the year of the failure without submitting a VCP application. Second, plan sponsors may increase the number of loans available to a single participant by retroactive amendment so long as the amended plan would satisfy legal requirements and plan loans were available to all participants or participants who are non-highly compensated employees. Third, plan sponsors can self-correct the failure to obtain spousal consent prior to taking a plan loan.

Finally, plan sponsors may now correct loan defaults – through single sum repayment, reamortization of the loan balance, or a combination of the two – without filing a VCP application. This is great news for plan sponsors. Under prior guidance, plan sponsors were

required to seek IRS approval of any attempt to restructure a defaulted loan. Following the elimination of the reduced VCP fee for loan defaults, it could be very expensive for a plan sponsor to file a VCP application for the simple purpose of correcting a defaulted loan. In addition, because of the time necessary for the IRS to process a VCP application, plan sponsors were often in the difficult position of reamortizing a loan pending IRS approval to allow the loan recipient adequate time for repayment before the expiration of the maximum loan term. Now, however, plan sponsors can confidently move forward with implementing a loan default correction without waiting for IRS approval. Corrections for loans that exceed the statutory maximum amount or term, or that do not satisfy the level amortization requirement, must still be corrected through the VCP process or Audit Cap.

The IRS has rightly concluded that an expansion of the self-correction process will promote voluntary compliance for retirement plans and reduce the costs and burdens of compliance on employers. And the IRS intends to offer examples on its website that will help plan sponsors identify significant versus insignificant operational failures, which may also expand the use of the self-correction procedure.

Even the best run plans have to be corrected now and again. If you have questions about how to correct an operational or documentation failure affecting your retirement plan, contact an employee benefits attorney at Verrill Dana.

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