EDUCATION

PODCAST: Biggest Changes in a Decade Impacting the US Retirement System

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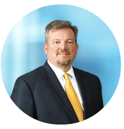
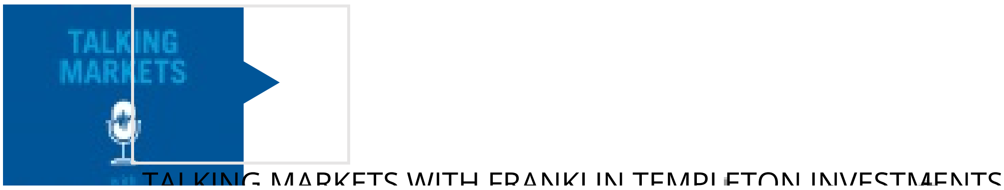


Drew Carrington, CFA
Head of Institutional Defined Contribution
Franklin Templeton Investments

On our latest "Talking Markets" podcast, Drew Carrington, head of Institutional Defined Contribution at Franklin Templeton Investments, and Michael Hadley, a partner at the Washington, DC law firm Davis and Harman, discuss noteworthy legislative proposals that may significantly affect retirement plans—including President Donald Trump's most recent executive order.

Tune in to hear more in our latest "Talking Markets" podcast.



Here are some highlights of the views of the speakers presented:

- Michael Hadley: The executive order President Trump signed last week is interesting because it was really the first time the president has laid out an affirmative agenda on retirement policy.
- Michael Hadley: While there are lots of proposed bills, the one that has had the most attention in the area of retirement is the Retirement Enhancement and Savings Act, or RESA.
- Drew Carrington: There's been some confusion about the rules regarding automatic enrollment and escalation. RESA really clarifies that and makes more assertive sorts of arrangements allowable.

A full transcript of the podcast follows.

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton. I'm your host, Richard Banks.

Ahead on this episode—an executive order by President Trump aimed at improving retirement security. We'll look at how the order could lead to more people getting access to retirement plans, why the age could change for minimum required distribution of dollars, and how current retirement legislation in Congress might be affected. Plus, breaking down a recent IRS ruling involving company matches.

Talking about it all is Michael Hadley, a partner at the Washington DC law firm Davis and Harman, who practices in the area of laws affecting retirement plans. He's joined by Drew Carrington, head of Institutional Defined Contribution at Franklin Templeton Investments. Drew, take it away.

Drew Carrington: Thanks, Richard. Let's start off with the big news: right before Labor Day, President Trump signed an executive order on Association Retirement Plans. Yaqub Ahmed, Franklin Templeton's Head of DC [defined contribution] and I were on hand for the signing, and it appears to be a game-changer. Can you tell us what this might mean for retirement policy?

Michael Hadley: This was really interesting because it was really the first time the president has laid out an affirmative agenda on retirement policy. Of course, one of his very first executive orders related to a refreshed look at the Fiduciary Rule. But this is the first time he laid out for his agencies what he wants to do from an affirmative standpoint, and the executive order doesn't change any rules itself. It would all require implementing regulations, but it directs the Department of Treasury and the Department of Labor to look at a couple of areas to try to improve retirement security.

The executive order asks the Department of Labor and Treasury to look at the question of open multiple employer plans [MEPs], which we think of now as Association Retirement Plans. What's an open MEP? Right now, small employers are not able to band together under a single plan. They have to each sponsor their own plan, unless they're related in some way, say in the same trade association, or like lawyers can all band together under a single plan. Otherwise most small employers have to sponsor their own plan, which increases costs, makes administration a little bit more difficult.

Essentially what the president has ordered the Department of Labor and Treasury to look at is how to make it easier for employers to band together under a single plan and increase coverage, because unfortunately, not enough small employers offer 401(k) or similar plans to their employees. There are issues related to Multiple Employer Plans both under the Department of Labor's jurisdiction—largely, this issue of who can join together under a single plan—as well as some issues that are under the jurisdiction of the Department of Treasury and the IRS [Internal Revenue Service], including what's called the "One Bad Apple" rule. In a MEP, any single employer screw-up could disqualify the entire plan, at least potentially, and that "One Bad Apple" rule is viewed as a barrier to the offering of these for small employers.

The president also talked in the executive order about thinking through—"gee, are Multiple Employer Plans or Association Retirement Plans—might they be a solution to getting coverage to gig workers and other independent contractors, which are a growing part of our workforce?" So that was the first part. The second part of the order, which is probably of most relevance to employers that already have a plan, is asking the Department of Labor to look at streamlining all these required documents and notices we send to employees. There's so much. They overlap, and they seem like they're coming all the time, and so the president ordered the DOL to see what we can do to streamline it. Even more importantly, he specifically called out the possibility of enhanced disclosure electronically, which I know a lot of employers would love to do more and more. Their employees are very connected. Unfortunately, the rules have just not caught up with how people use internet and smartphones, etc.

Lastly, the order tells the Department of Treasury to look at the rules for required minimum distributions. These are the rules that basically say, in a plan or an IRA [individual retirement account], once you reach 70-½, you need to start taking your money out. And they do so by basically saying each year some percentage of your account has to be distributed, and it's based on life expectancy. But the life expectancy tables haven't been updated in many, many years, and, of course, people are living longer. What the president ordered the Treasury to do is say, "let's take a look at those life expectancy tables and update them and think about whether they should be updated automatically, periodically, to reflect an increase life expectancy."

Basically, what this would mean is that when somebody gets to age 70-½ and they're taking distributions from their plan or IRA, if the life expectancy tables are updated, that means that the amount that they have to take out each year is less than it is under current law. Doesn't mean you can start later. You still have to start at the same time, but you'll be able to preserve assets at least on a tax-preferred basis for a longer period of time. That's basically the order, Drew. And, what's really interesting about it is it's really the first time the administration, from the White House level, has sort of looked at it as a comprehensive look at what they want to do from a regulatory standpoint. We expect both Treasury and DOL to start working towards proposed regulations and other guidance that we can expect over the next couple months.

Drew Carrington: Great perspective there, Michael. Obviously, a very big development. More broadly, it appears we could be looking at more legislative activity addressing retirement plans in the next three to six months than we've seen in a decade. Could you walk us through the policy landscape?

Michael Hadley: A great question, Drew. This order actually has an important interplay within a piece of legislation that we're watching most closely up on the Hill. While there are lots of bills that are sort of proposed, the one that has the most attention, at least in the area of retirement, is a bill called the Retirement Enhancement and Savings Act, or RESA. That's a bill that passed through the Senate Finance Committee unanimously in 2016 and is broadly supported throughout the Senate because it has a number of bipartisan changes to retirement policy. None of them are earth-shattering, but important incremental changes. The RESA includes a number of provisions that would be of interest to lots of different types of plans, both trying to increase savings, increase coverage, etc. RESA actually has an open MEP provision. So it's very similar to what the president is asking the Department of Labor and Treasury to do through regulations.

One important implication we've been thinking about here over the Labor Day weekend is—"does that mean that provision of RESA comes out leaving the rest of it, or might stay in with the legislators thinking—no, that's our proposal, we want to keep moving it?" We're going to have to see as the Senate and House return from their break to do their last couple of days of legislating before the election.

But, in any event, we still think RESA is really the piece of legislation to watch because it's broadly supported. It has bipartisan ideas that are supported by industry, largely supported by industry, and by consumer groups and has made the most progress.

Drew Carrington: You mentioned improvements to saving itself. I know there has been some confusion about the rules regarding automatic enrollment and escalation, and RESA really clarifies that and makes more progressive or assertive sorts of arrangements allowable.

Michael Hadley: That's right. Yeah, so, back in 2006, Congress passed really the last landmark pension legislation, the Pension Protection Act, which did a lot of things, but one of the things it did was really encourage employers to harness the power of inertia by using automatic enrollment, default investments and the like. One thing that has emerged from those very positive changes is that the way Congress set it up, they discouraged adequate savings levels.

For example, there is a provision that came out of the Pension Protection Act encouraging employers to escalate their employee savings rate over time. By that, I mean you start at 3% and then the next year employees automatically go to 4% unless they opt out, and that escalation is a great way of getting people as they continue to get increases in their salary to save it right into their plan. Current law, at least for those using a nondiscrimination safe harbor, requires the employer to stop at 10%. I think studies have shown that over time, especially for people who begin saving later in life, the 10% may not be enough. The RESA provision would remove that 10% cap.

The employer that's not using one of these safe harbors is not subject to the 10% cap, but actually a lot of employers put a cap at 10% anyway just because they have this perception that they are supposed to stop at 10%. That's not the law, and this RESA provision, if it makes it to the president's desk, would address that. We are sort of getting more people in the planning, and then, in the next provision, it's getting people to save more.

Drew Carrington: What is alternative to a safe harbor sounds like something unsafe, and so, I can see why, even plan sponsors who are not using that arrangement, might be concerned. I think that repeal is pretty attractive. The last group of things in RESA, the kind of the high-profile things, have to do with this transition from savings to spending, either at retirement or prior to retirement. I know there has been a number of discussions. This is an area we focus on here at Franklin Templeton on a regular basis, but RESA, in particular, has a couple of components of the bill that address that how you communicate to participants who are approaching retirement and then the responsibilities that the plan sponsors have for selecting investment choices, menu options for participants who are close to retirement.

Michael Hadley: Sure. The RESA provisions, there are actually three, that all sort of fall under the rubric of lifetime income. I sort of hate that word because it's really not lifetime, it's retirement income. Three things, the first is it would address the fiduciary obligations for a plan committee that puts in place an annuity distribution option, largely building on rules the Department of Labor has already put in place. It would clarify some of the rules, so that a fiduciary could feel like, "If I offer this annuity evidence distribution option, I am not going to be tagged with liability if, 30 years from now, the insurance company goes under. I can't predict that." That's the first thing.

The second thing that the bill would do is make guaranteed income products, like annuities and GLWBs [Guaranteed Lifetime Withdrawal Benefits], more portable, sort of address some of the portability problems.

The third provision, and the one that probably has the most controversy, is a provision that would require participants to be provided on their benefit statements a calculation of the amount that their income can generate in retirement income, sometimes called a lifetime income disclosure. And this is one of the few pieces of RESA that I would say actually does not have full support of the industry and plan sponsor groups. The reason is that, while lots of plans provide this number, there are plenty of folks who do not think it should be mandatory and are concerned about some fiduciary obligations of that. And, there are some folks who do not like the way that the bill describes how the calculations are supposed to be done. The bill would basically require it to be done in the form of an annuity, some sort of guaranteed income calculation. Lots of plans do it totally differently, and this would require a change. While the notion of helping people think about their current account in terms of what it generates an income is pretty well-accepted in the marketplace, this particular provision is really one of the few that, at least in its current form, does not have sort of broad support of everybody.

Drew Carrington: Yeah, I think there are some who oppose it, not so much because they oppose the specific method but because they oppose having the bill choose a method. I think for many of us we don't know yet what is the most effective way to communicate that current balance as an income amount in retirement in order to drive the sorts of behaviors that we want participants to engage in to improve their retirement readiness, so until we have done more research and have more data, it may be premature to pick a single method. The fact that that particular component has a little bit of controversy on it might be a good jumping off point to talk about what's the process for RESA getting passed, like what has to happen next, where do we stand in the legislative process?

Michael Hadley: It's a great question and one we are all sort of struggling with here. On the Senate side, as I said, the bill had a tremendous amount of support and probably could pass with near unanimous support, it actually could go through what we call U-C, meaning you don't even have to bring it up for debate. There are one or two senators that are holding it up to try to deal with some unrelated pension issues, but it could pass the Senate fairly quickly.

On the House side, things are little different. The Chairman of the Ways and Means Committee, Kevin Brady, has said that he would like to do some retirement improvements but he's not willing to just take RESA as it is. He would like to do retirement improvements as part of a broader package that he calls Tax Reform 2.0. The 2.0 is because 1.0 was the Tax Reform Bill passed at the end of last year, and he said that he would like to do this three buckets of tax reform 2.0. One bucket would make the individual tax cuts that were passed last year permanent. Another bucket of retirement provisions, and then the third bucket related to sort of small business innovation and enhancement. That retirement package, although we have not seen it yet, will probably include some of these RESA provisions as well as additional provisions that Kevin Brady would like to try to move, like new savings vehicles and enhancement of 529 plans.

So really, the process to get this done—you've got to have the House and Senate bill passed that are identical, and some combination of the RESA package in the Senate and some sort of retirement package in the House is going to have to be put together in order to move this to the president's desk. It is possible that that could move on its own, more likely that it gets attached to some piece of legislation that has to pass. An example would be the spending bill that's going to need to be passed by the end of September or some sort of continuing resolution or something to keep the government open—that's must-pass, and things that have bipartisan support could be attached to it.

We could also see some version of RESA passed in the lame-duck session. If you worry that folks will not want to pass legislation right before an election, there's very little political incentive to do so, there is often hope that the lame-duck session after the election can move some pieces of legislation that are not considered to be controversial. RESA could be some part of that.

Drew Carrington: We spent all this time up to now talking about RESA, but there's actually a whole bunch of other bills that have been proposed in Congress as well—both on the House side and the Senate side—addressing retirement issues. I don't think we need to go through the entire laundry list, but maybe I'd just be interested in your thoughts on, kind of, what's driving this interest on retirement-related legislation today, what are the sort of standout other bills that have been proposed and maybe even handicap whether any of those have any chance of passing?

Michael Hadley: It's sort of funny. In Washington, having been working on retirement policy for at least five years, it has been so dominated by the Department of Labor's fiduciary proposal, which was the first for many, many years that really split Republicans and Democrats. I am lucky that I have worked in retirement policy because it's generally bipartisan. Most Americans and most of the representatives want to make sure we are saving enough. That's a pretty bipartisan kind of idea. Now that the fiduciary rule, at least the DOL's piece of it, has subsided, there have been a lot of ideas that have been fermenting and are now getting some attention. I will mention a couple.

There's a bill that would increase the cash-out limit. Currently it's $5,000, and that's the limit under which you can cash somebody out when they terminate employment to sort of prevent people from leaving small accounts behind. There is a bill in the House that would increase that from $5,000 to $7,600, indexed for inflation. On the Senate side, there have been a number of bills, some are close, but not identical, to the RESA that have been introduced, including a recently introduced group of four bills, introduced on a bipartisan basis by Senators Young, Cotton, Heitkamp and Booker that are all sort of aimed at getting people to save more, have emergency savings, encourage them to save their tax return. Two of those bills are similar, but definitely not identical, to what we talked about in RESA.

Because none of those folks are on the committees of jurisdiction, we continue to think that the RESA provision is really the one to be watching. I will mention one last one. There is a bill introduced by Senator Warren and Senator Daines called the Retirement Savings Lost and Found Act that would create some sort of national pension registry where everyone would be able to go and look and see where they might have a former retirement account. As people change jobs, money is moved into IRAs, to annuities, as plans merge, we've begun to see a problem with people losing track of their savings, and this bill would create a national registry to help people kind of locate their life savings.

While all those are important; they are all giving you a sense of what we are talking about here in [Washington] DC. I continue to think that, realistically, RESA is the most likely vehicle. So, anything that is going to pass in the retirement space, probably has to be part of RESA, and so, many things could be added although I think the goal on the senate side is to keep it as simple as possible.

Drew Carrington: As you noted the DOL fiduciary rule, I suppose, is history at this point, and what are they focused on now? Certainly, we have heard a lot of activity and interest on the part of the DOL, and, in terms of how plan sponsors deal with lost participants. Maybe you can talk a little bit about the extent to which the DOL is paying attention to this lost participant issue?

Michael Hadley: Yes, it really has become sort of their key enforcement agenda. The Department of Labor's Employee Benefit Security Administration has a number of regional offices, and if you are a plan fiduciary, and you get contacted with an audit, it's going to be from one of those regional offices. Starting originally in the Philadelphia office but now really expanding, part of the questions that they are asking when they audit a plan is "we want to know who you have who has terminated employment and who is due a benefit, and what you are doing to try to find those people when you unite them."

It's been described as very aggressive, and it's certainly gotten the attention of a number of plan-sponsor trade associations here in Washington. I personally participated in at least three meetings with the Department of Labor to talk about this. From the DOL's perspective, they love this enforcement mechanism because they are really successful at contacting participants and reuniting them with their money, because they can send a letter from the government saying you may have money and that actually gets opened. From the standpoint of plan sponsors, it's scary because of the aggressive nature, and they really think that plan sponsors should be going, if not to the ends of the earth, pretty close to try to find people. I think where this ultimately leads is we are probably going to have some guidance from the Department of Labor on best practices, so at least we have a baseline to follow.

Drew Carrington: Speaking of agencies that impact the retirement arena, the other place of course is the Treasury Department. Just in the last couple of weeks, we have seen a new private-letter ruling from the Department of Treasury on student loan repayments and how they are related to the 401(k) plan. This is really an interesting phenomenon, and I will be interested to hear what you think about it. From our perspective, this broader view of financial benefits—this more holistic view, the concept of financial wellness, integrating not only the 401(k) plan but thinking more broadly about things like student loan debt as an example—is an area where we see employers focused on, and this new pronouncement and the program that it allows is, I think, a really interesting change in that it sort of institutionalizes this broader view.

Michael Hadley: This private-letter ruling has got more attention in the last couple of weeks than I think any private-letter rulings that I've worked on in quite some time. The private-letter ruling is just a letter issued from the IRS to one taxpayer. Only one taxpayer can rely on it, but it is made public without any identifying information, and so we get a sense of what the IRS ruled on. The design that the IRS ruled on was essentially this. It involved a 401(k) plan with a matching contribution. If the employee contributed a certain amount of their own money, then they got a matching contribution. And the employer decided, you know what, we have got employees who cannot contribute to the plan because they're having to pay back student loans. So, what we will do is, we will say to the employee, if you have to payback a student loan, and you are putting as much into a student loan as you needed to have put in to get our match under the 401(k) plan, we'll go ahead and provide you the matching contribution essentially on the student loan repayment. You don't have to actually contribute to the plan to get the match.

The IRS ruling was really just on one technical provision in the 401(k) regulation—does it violate what's called the contingent benefit rule, and the IRS said, "no, it doesn't." Hidden in the ruling are a few interesting facts. For example, the IRS basically said that this new contribution has to meet the nondiscrimination rules. That's not surprising. So, depending on your plan demographics, it may not work for everyone. They also said that it has to meet the rules for eligibility. Again, you are not discriminating in favor of your executives. I think most student loan repayments will be made by your younger employees anyway, and as you said Drew, it's interesting because it's the first time the IRS has blessed sort of this idea of integrating the retirement contribution with some other financial savings or repayment than an employee has to do. You could easily see this expanding beyond the particular design that was described in the ruling, and I certainly know that a lot of advisers, a lot of plan sponsors, are taking a look at that and saying "does that make sense for me and if so, does this design make sense for me, is there another way we should expand it?"

For example, this is there to help your younger employees that have significant student loan debt. What about some of your older employees that don't have student loans but now need to save for their children's college? Might you provide a match on a 529 contribution? Those are the sorts of next steps. There have been some legislative proposals related to this. Because this private ruling is basically saying that the design works under current law, you don't need legislation. The legislative proposals that I have seen have made it a little bit easier to run from the nondiscrimination test and streamline administration, but apparently now, the IRS is saying you can do this under current law.

Drew Carrington: Between this and the proposal around universal savings account or emergency savings accounts, I think there is this broader view about financial wellness both on the regulatory and legislative front and that's pretty interesting. We talked a little bit about the fact that the DOL rule is, because of the Fifth Circuit's ruling, is no longer applicable. The SEC has taken up the best interest torch. Where does that stand, and is that going to have an impact on retirement plans?

Michael Hadley: Let's start with kind of where it stands. The comment period has now closed on the proposal. The proposal, over 1,000 pages, I have read the whole thing but, I promise I won't bore you with every page. And three-month comment period, so most stakeholders have now had a chance to kind of weigh in. The Chair of the SEC [Securities and Exchange Commission], Jay Clayton, has basically said he really wants to get this done. This is a priority for him. I think his goal would be to issue a final regulation by the end of the year. He is going to have to make sure that he can get the votes that he needs among the commissioners, and it seems like, if he can sort of thread the right needle between what his Republican and Democratic colleagues are looking for, that he may be able to do that. If it's not finalized by the end of the year, I would be looking towards early next year for it to be finalized.

The centerpiece of the proposal would require brokers, when providing advice to so-called retail customers—people that are saving for household and similar reasons—require them to act in their clients' best interest, and it sort of lays out what that means, sort of turns best interest standard into a number of components.

The SEC's proposal would have an impact on retirement plans. First of all, it would cover recommendations that brokers make in connection with rollovers, and that was an area that the DOL is very focused on—how do we make sure that when participants leave employment, if the ability to roll over that rollover really is in their best interest, because lot of plans, especially large ones, are really fantastic, low fees, great investments. The SEC's rule would cover that. Plan sponsors that are sort of concerned with the DOL rule going away—are my participants going to be adequately protected—the best interest standard is trying to do that.

The SEC would also cover advice given directly to plan participants because it, at least, appears that the SEC views that as essentially a retail level of advice. The SEC's rule would also sort of formalize the rules for advisors—individuals covered by the Advisers Act—that provide advice on a fee basis. It's not supposed to change the fiduciary standard which has always been there but lay it out in one place, and that would be helpful to plan sponsors that get advice from advisers because it sort of formalizes that fiduciary standard that's always applied. Lastly there are some new disclosures, including something called the Relationship Summary. Many of that would not be provided to plans, but, depending on how the SEC interprets it, some of that may actually be provided to plans or to their participants. It's supposed to lay out in plain English, as much as you can ever lay out securities rules in plain English, what the relationship is between the broker and advisor and the customer, what the standard is going to apply, the conflict of interests, etc. It's supposed to be no more than four pages, and it's possible there could be some more disclosures that either plan fiduciaries or plan participants receive. I think most people view this best-interest proposal, while certainly not perfect, and there are a lot of comments on it, as a good step forward. There is broad agreement, I think pretty much among everyone, that it's important that when individuals receive advice that it is in their best interest. The details of course matter and that was a lot of the controversy around the DOL, not this notion of acting in best interest, but the details as to how you comply. The SEC rule, I think is, in a place where probably will be formalized within the next 12 months.

Drew Carrington: That's a lot of activity in Washington that may or may not change how we advise our clients, what clients and employers do for their employees, what kinds of things employees or plan participants have access to, how we communicate with them. Certainly, the biggest set of changes since the Pension Protection Act of 2006.

Thanks very much, Michael.

Richard: That's it for this edition of Talking Markets with Franklin Templeton. Thanks to all our contributors. If you enjoyed their insights and would like to hear more, check out our archive of previous episodes and subscribe on iTunes, Google Play, or just about any other major podcast provider. So, until next time when we uncover more insights from our on the ground investment professionals, goodbye!

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