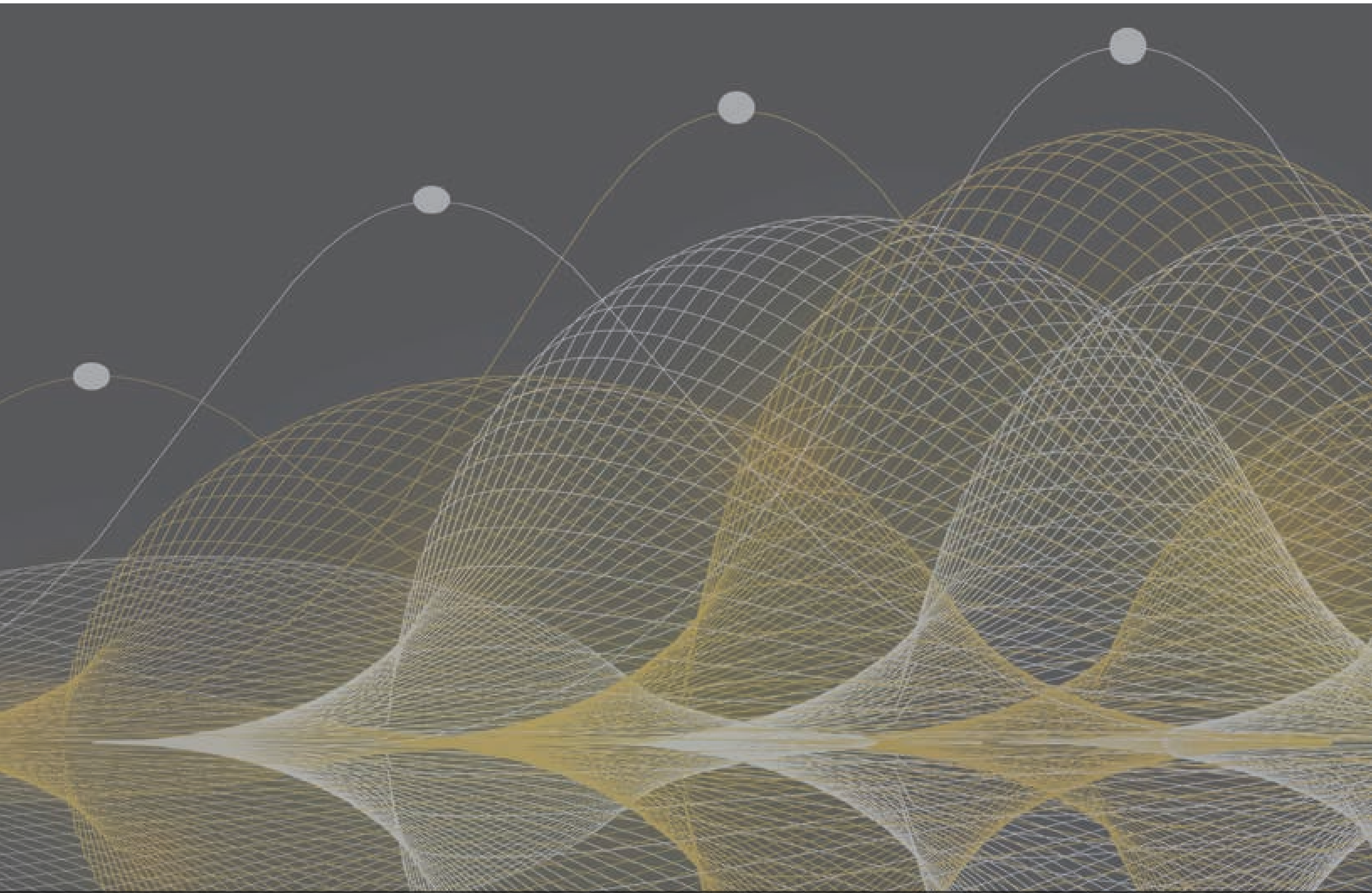

The Impending Convergence of Baby Boomers and Required Minimum Distributions

PREPARING FOR THE BIG WAVE OF ASSET OUTFLOWS

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Facing an unprecedented influx of retirees and the onset of associated mandated withdrawals from retirement plans, the retirement industry needs to acknowledge, understand and prepare for an unprecedented outflow of assets.

Defined Contribution plans continue to grow in popularity and the inflow of cash to retirement programs is likely to continue unabated for some time, and features such as auto-enrollment and re-enrollment will perpetuate the flow of assets into these plans. However, there appears to be a little-recognized threat to the ultimate growth of plan assets due to a tsunami of mandated withdrawals for baby boomers that is about to arrive on the shores of the retirement industry. This onslaught of mandatory distributions – also known as Required Minimum Distributions (RMDs) – has been on the horizon for many years and has the potential to alter the landscape of the retirement industry. It appears that little attention has been given to the logistics associated with this impending – and massive – distribution that will result in a significant exit of assets.

Beginning in 2016, the first of the baby boomers will reach 70½ years of age and must begin taking Required Minimum Distributions.

HOW SIGNIFICANT IS THE RMD ISSUE?

Beginning in 2016, when the first of the baby boomer generation[1] reaches 70½ years of age, a growing share of applicable retirement savings will become subject to RMDs, which is the annual minimum amount a retirement plan account owner must withdraw beginning in the year he or she reaches age 70½. As a result, throughout the next 20 years, billions of dollars annually will be forced from retirement accounts through distributions that will, in many cases, be taken in the form of a single large annual payment.

While RMDs have been required for many years, the sheer number of individuals comprising this generation, in conjunction with the size of their accumulated retirement wealth, will magnify the impact of retirement withdrawals once they reach the RMD threshold.

The impact of these events will be substantial and will pose a challenge to the retirement industry. After decades of asset accumulation, this unbridled exit of funds is poised to have a material and adverse impact on the retirement companies that manage these accounts. Firms facing this onslaught will need to be thoughtful and creative in managing distributions, and may need to consider alternate distribution methods when executing RMD compliance. Creating and adopting new strategies to retain, redeploy or otherwise slow the exit of assets that result from RMDs could prove crucial for the industry's wellbeing.

HOW WE ARRIVED AT TODAY'S RMD REALITY

The rise of defined contribution plans resulted from the passing of several legislative acts in the 1970s and 80s, including the Employee Retirement Income Security Act and the Revenue Act of 1978. Instead of relying solely on the employer for retirement income, the legislation enabled employees to fund and gain a measure of control and flexibility over their individual retirement assets. This also resulted in the transition of retirement funding responsibility for many from the employer to employees. However, with the increase in defined contribution plan assets, there was a growing concern that taxpayers were using these retirement vehicles as a means to accumulate tax-free wealth rather than as a means to ensure an adequate retirement income. To address the issue, the Tax Reform Act of 1986 was passed requiring taxpayers to begin taking annual distributions from their tax-deferred defined contribution plans upon reaching the age of 70½.[2]

Common industry wisdom assumes that voluntary withdrawals will increase as individuals transition from the accumulation phase of their life into spending assets to fund retirement. However, the approaching RMD wave appears to have crept up on the industry, with seemingly little preparation or acknowledgement of this inevitable event.

Most (but not all) retirement accounts are subject to the RMD rule, which states that RMDs must be taken from traditional IRAs and IRA-based plans such as SEPs, SARSEPs, SIMPLE IRAs, and SEP IRAs. Employer-sponsored retirement plans are also subject to the RMD rule, including profit-sharing 401(k), 403(b) and 457(b) plans. Minimum distribution rules also apply to profit sharing and other defined contribution plans.

ASSETS IN SCOPE AND RMD CALCULATIONS

According to the Investment Company Institute (ICI), at the end of 2014, U.S. retirement assets totaled an incredible $24.7 trillion. Employer-sponsored defined benefit plans, as well as state, federal and local government plans, accounted for a combined $8.4 trillion of these retirement assets. The remaining (and by far largest) component of the retirement assets pool was represented by IRAs ($7.4 trillion[3]) and Defined Contribution Plans ($6.8 trillion). Add to this a reported $2 trillion in annuities and you have $16.2 trillion in assets that may be subject to a required withdrawal at some future point[4].

With an estimated $16.2 trillion in assets at the end of calendar year 2014, IRAs, defined contribution plans and annuities account for approximately two thirds of total retirement assets in the U.S.[4]

Understanding how RMDs are calculated can help provide a clearer picture of the massive outflow of cash projected to occur. The RMD is calculated using the Distribution Period tables published by the IRS and the year-end balance of the retirement assets subject to the mandatory distributions. The amount of the required withdrawal is calculated by dividing an individual's year-end balance from the previous year by the Distribution Period factor for the account owner's age at the time of the distribution. The resulting number represents the amount of the individual's minimum distribution for the current tax year.

Below is an example of this calculation for an individual at age 70½ with a retirement balance (subject to distribution) of $250,000. (Based on the IRS Uniform Lifetime table [Figure 1, on the next page], the distribution period of 27.4 is used for this calculation.)

Prior Year-end Balance / Distribution Periods Factor = Current Year RMD

$250,000 / 27.4 = $9,124.09

In this case, the resulting withdrawal of $9,124.09 represents 3.65% of the retiree's retirement balances at the time of the calculation. Note that, over time, the formula results in a growing distribution percentage. However, it is eventually applied against a declining balance as withdrawals (likely) begin to exceed earnings in the account.

IRS Uniform Lifetime Table – Figure 1

RMD Age	Distribution Period	% of Balance	RMD Age	Distribution Period	% of Balance
70	27.4	3.65	81	17.9	5.59
71	26.5	3.77	82	17.1	5.85
72	25.6	3.91	83	16.3	6.13
73	24.7	4.05	84	15.5	6.45
74	23.8	4.20	85	14.8	6.76
75	22.9	4.37	86	14.1	7.09
76	22.0	4.55	87	13.4	7.46
77	21.2	4.72	88	12.7	7.87
78	20.3	4.93	89	12.0	8.33
79	19.5	5.13	90	11.4	8.77
80	18.7	5.35			

Source IRS [5]

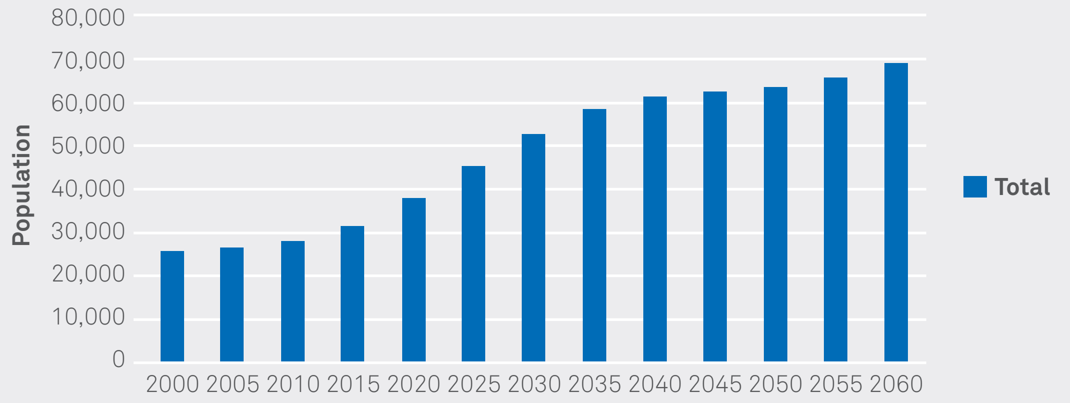
THE POPULATION TRAJECTORY – AGE 70+

Based on information published by the US Census Bureau, the population of individuals age 70 and older totaled approximately 25.5 million in the year 2000 (see figure 2 on the next page, which also shows the projected population in this group throughout the subsequent 45 years). By 2015, this number has grown by 24%, and that cohort now stands at 31.7 million. While that 15-year period (2000-2015) reflected a substantial increase in the number of those over 70, this demographic takes a dramatic upturn going forward. The populace of individuals 70 and older is projected to swell to 37.9 million in the next five years, and will more than double from the year 2000 baseline to 58.7 million throughout the ensuing 20-year period (2015-2035).

The growth of 70+ individuals begins to level off after the year 2035 and appears to peak in 2060 with a projected 69 million people filling this demographic.

In the next 20 years, the cohort of those over the age of 70 will swell to 58.7M people.

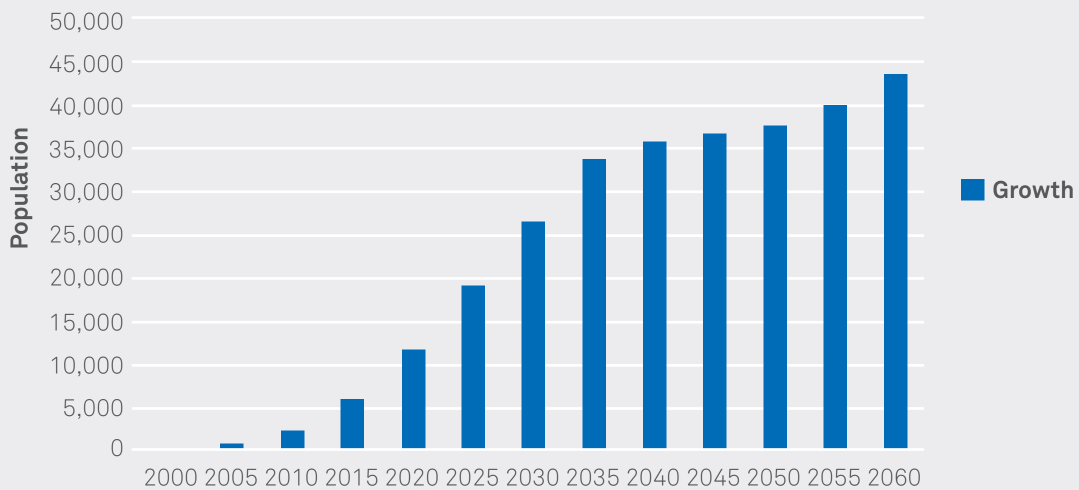
Total U.S. Population 70 and Older – Figure 2
(in thousands)



Source: U.S. Census Bureau

Figure 3, below, illustrates the growth in the number of individuals in the 70+ demographic for the period 2000-2060. Note that the trajectory of this group is most dramatic over the 20-year period from 2015 to 2035.

Growth of 70+ U.S. Population– Figure 3
(in thousands)



Source: U.S. Census Bureau

CONVERGING ELEMENTS

While the actual valuation of current RMD outflows and projections of future distributions are inexact in the absence of hard data, consider the following statistics:

- The value of retirement assets for all RMD-eligible plans currently totals an estimated $16.2 trillion.
- The current population of 50-69 year olds who will reach RMD status over the next 20 years will increase by more than 27 million individuals. By 2035, the total number of retirees taking RMDs could swell to 58.7 million individuals according to census projections.
- It is estimated that more than 65% of current traditional IRA investors (and their assets) will enter into the RMD strata in the coming 20-year period.(6) If these projections are correct, up to $10 trillion in assets will be subject to mandatory withdrawals over the next two decades.
- A first-year withdrawal, based on the current IRS formula, requires a distribution of 3.65% of eligible assets. What's more, the percentage grows as the retiree ages and jumps to 5.35% for that same individual at age 80. At age 90, the mandated withdrawal percentage leaps to 8.77% of the accountholder's balance.

The enormous magnitude of these mandated withdrawals is staggering when you apply these fractions to asset valuations in the trillions of dollars. Yet, this is the reality the industry faces in the coming years.

EXPLORING SOLUTIONS: RETENTION STRATEGIES THROUGH DISTRIBUTION ALTERNATIVES

Be it a voluntary withdrawal or an RMD from a retirement account, any solution that could stem the massive outflows of cash, or at least slow the exit of assets, would be groundbreaking. To be successful, any alternative distribution solution must also provide a meaningful benefit to retirees.

Examining the expenditures of voluntary withdrawals from retirement accounts may enable the industry to craft future distribution alternatives. Research conducted and reported by the ICI indicates that 41% of withdrawals from retirement accounts are used to pay living expenses in retirement. Other reported uses of withdrawals from retirement plans, according to the research, include expenditures for healthcare (22%), home purchase, repair or improvements (22%), or were used to pay educational expenses (6%).(7) However, 38% of survey respondents to the ICI survey also indicated that withdrawals are actually reinvested or saved in other accounts.(4) This suggests that some meaningful portions of cash withdrawals are taken not for a specific need, but rather because they were required. Further supporting this conclusion, the ICI published statistics that show a 40% drop in withdrawals among those 70 and older in the year 2009 – the same year that the IRS suspended RMDs due to the financial crisis.

Those who solve for this issue by developing investor-friendly solutions may win the battle of asset retention.

Addressing the needs of the accountholder and their use of both voluntary and involuntary withdrawals in retirement will be paramount to a successful distribution strategy. One current example of a successful distribution alternative can be found in the life insurance industry. Currently, many life insurance companies offer beneficiaries an interest-bearing account with a checkbook/debit card option in lieu of a lump-sum claim payment. This option provides the beneficiary with a convenient tool for settling the expenses and affairs of an estate while, at the same time, earning interest on the funds. In these instances, the assets stay with the insurer for months and sometimes years or decades while the beneficiary continues to receive interest income on the remaining balance. A program of this type may also prove useful to the retirement industry as it grapples with the exorbitant growth of minimum distribution payments.

A review of the uses of cash in retirement, as previously illustrated, may offer additional insight into where the industry could look for developing cash distribution alternatives. Per the ICI study, more than 22% of the respondents indicated that retirement funds were used to pay medical expenses. Another solution for consideration might incorporate a virtual wallet for healthcare expenditures into which RMDs would be deposited. This would offer beneficiaries the convenience of accessing needed funds for anticipated healthcare expenses without having to manage their annual distributions. Other solutions might employ debit cards linked to interest-bearing accounts or even prepaid gift cards that would offer retiree access to both RMDs and voluntary distributions of their retirement assets.

It is estimated that more than 65% of current traditional IRA investors (and their assets) will enter into the RMD strata in the coming 20-year period. If these projections are correct, up to $10 trillion in assets will be subject to mandatory withdrawals over the next two decades.

PREPARATION AND PRECAUTION – STEPS IN THE RIGHT DIRECTION

The evolving landscape of consumer payments may create distribution options and strategies beyond those we can currently envision. It is also likely that the payment needs and preferences of retirees will change in the ensuing decades. What is clear, however, is the need for retirement organizations to begin planning for this inevitable change in the distribution dynamic and come to grips with the need to create and offer alternatives to the annual mandatory outflows that are the norm today.

We are standing at the threshold of an astounding withdrawal of assets that, for the most part, is prescript by tax law. At issue is the ability of the retirement industry to manage this massive outflow of assets. To do so, the industry will need to be creative and understand the needs of their post-retirement clients. Those who solve for this issue by developing investor-friendly solutions may win the battle of asset retention. The ability to stem the tide of cash flowing from these retirement programs, even by a few months, will have a sizeable impact on the companies holding these assets and will better position these firms to weather the impending tsunami of RMDs.

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[1] Those born between 1946 and 1964.

[2] TIGTA Audit Report reference number 2015-10-042

[3] Roth IRAs are included in the total IRA asset total but are not subject to RMDs.

[4] U.S. retirement asset figures are taken from the 2015 Investment Company Fact Book, https://www.ici.org/pdf/2015_factbook.pdf, p.137.

[5] IRS RMD Worksheets: https://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Required-Minimum-Distribution-Worksheets; Uniform Lifetime Table from IRS Publication 590-B (2014), Distributions from Individual Retirement Arrangements (IRAs), http://www.irs.gov/publications/p590b/

[6] ICI Research Investor Profile: Traditional IRA Investors' Activity, 2007-2013, https://www.ici.org/pdf/rpt_15_ira_traditional.pdf, p.42

[7] Use of withdrawals taken from the 2015 Investment Company Fact Book, https://www.ici.org/pdf/2015_factbook.pdf, p. 159. Multiple responses included in survey results; ICI IRA Owners Survey. ICI Research Perspective, "The Role of IRAs in U.S. Households' Saving for Retirement", 2014, https://www.ici.org/pdf/per21-01.pdf.