# Analysis&Perspective

## Is Annuitization of DC Plans an Answer to Retirement Security Questions?

Since the financial crisis of 2008, when employees saw their tax code Section 401(k) plan balances plummet, retirement income security has been a hot-button issue. As the retirement world becomes a "defined contribution plan universe," there has been a lot of talk about how to ensure that these Section 401(k) plans provide a stream of income for the life of the plan participant.

The Obama administration is now talking about annuitizing Section 401(k) plans as one possible way to guarantee lifetime income. A fact sheet released by the White House Jan. 25, in anticipation of the President's State of the Union Address Jan. 27, said the administration is "promoting the availability of annuities and other forms of guaranteed lifetime income, which transform savings into guaranteed future income, reducing the risks that retirees will outlive their savings or that their retirees' living standards will be eroded by investment losses or inflation."

Some policymakers, academics, and practitioners agree that one solution to the retirement security problem is to annuitize Section 401(k) plans. However, most agree that this is just part of the discussion.

J. Mark Iwry, senior adviser to Treasury Secretary Timothy Geithner and deputy assistant treasury secretary for retirement and health policy, told BNA Jan. 25, "we're not limiting our policy interests to annuities. The topic is lifetime income in retirement, and helping people manage their savings." The policy interest is to help people with the decumulation phase, Iwry said. This does not necessarily mean a commercial annuity, as opposed to an annuity paid by a defined benefit pension trust, some other long-term stream of payments, or another payout strategy that takes into account the uncertainty about how long people will live, and other risks such as inflation or investment risks, he said.

The government is looking at annuities in a balanced way that takes into account all of the relevant factors, including cost, transparency, solvency risk of the entity making the annuity payments, and portability, Iwry added.

The Labor Department and the Treasury Department are expected to release imminently a request for information (RFI) about placing an annuity option in defined contribution plans. Iwry said that the upcoming RFI will refer to various issues surrounding lifetime income and give people plenty of time to respond.

In addition, the regulatory agendas of both the Internal Revenue Service and DOL mentioned annuitization of defined contribution plans as a priority (6 PBD, 1/12/10; 37 BPR 172, 1/19/10; 225 PBD, 11/25/09; 36 BPR 2733, 12/1/09).

On the legislative level, on Dec. 3, a group of senators introduced the Lifetime Income Disclosure Act (S. 2832). Under the bill, employers would be required to set forth the annuity equivalent of participants' account-based benefits on at least a yearly basis (230 PBD, 12/4/09; 36 BPR 2766, 12/8/09).

IRS has begun to address this issue by releasing two private letter rulings concerning annuities in defined contribution plans.

The reaction from practitioners and plan advisers to annuities in defined contribution plans has been mixed, as:

- the cost of annuitizing plans may be prohibitive;
- there is not strong demand from participants for annuities;
- there may be fiduciary liability exposure from purchasing annuity products for plans; and
- the addition of annuities may add to plans' administrative burdens.

### The Psychology of Annuities

Those who spoke to BNA agreed that the psychology of annuities was one of the impediments to their popular use.

David C. John, senior research fellow and deputy director of Brooking Retirement Security Project, the Heritage Foundation, told BNA Jan. 15 there are several reasons participants do not annuitize their Section 401(k) plans.

First, is the "lump-sum effect," John said. When people look at their Section 401(k) balances, they feel rich, John said. "People have a very hard time giving up more money than they ever had and the feeling of being rich, for the amount of monthly income that they will be guaranteed," he said. For example, people look at $100,00 in their Section 401(k) account, and rather than see that they will get $6,000 annually, they see that they will get $500 per month, he said.

Second, people have the fear that they will sign the annuity paper today, die tomorrow, and their heirs will get nothing, he said.

Third, there is a popular dislike of insurance companies, John said. People rightly believe annuities are expensive and that they are just giving the insurance company a huge amount of money for a pittance, he said.

Robert Toth, of the Law Office of Robert J. Toth Jr., Fort Wayne, Ind., agreed that "participants don't trust insurance companies," and people "don't like giving up their account balances." In addition, many advisers do not like annuities because they think it is a bet against the insurance companies, Toth told BNA Jan. 14.

Bill McClain, a senior consultant in Mercer's U.S. retirement, risk and finance business, Seattle, agreed that many people have conceptual difficulties with annuities. "People have a hard time translating a lump sum into a life income," he told BNA Jan. 21.


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The kind of disclosure proposed in the Lifetime Income Disclosure Act would be helpful for people to start seeing that kind of comparison, McClain said. People have to digest over time what a lump sum translates into, he added.

## The Concerns With Annuities

There are several concerns with offering annuities as part of defined contribution plans that have to be overcome if they are to become more popular, those interviewed agreed.

The psychology against annuities, as mentioned above, has to be overcome.

**Cost.** The cost of annuities must be reduced. John said insurance companies have priced annuities for a longer longevity rate than the average population. However, as the market for annuities grows, the customer base will change and the longevity assumptions will become lower, thus lowering the cost of the annuity fees, John said.

Jeffrey N. Clayton, partner, Callister Nebeker & McCullough, Salt Lake City, Utah, told BNA Jan. 20 group annuity contracts are difficult and expensive to get out of, and he tells clients not to buy them for their Section 401(k) plans. He explained that an insurance company usually will not give a plan sponsor an annuity option for a Section 401(k) plan unless the plan is part of an annuity investment contract.

Clayton said another disadvantage is that if an employer offers an annuity option with a group annuity contract it is often expensive to change providers due to fees charged by the insurer. If there is a plan merger such as in an acquisition, the presence of an annuity may complicate the merging of plans. For example, if a big company buys smaller companies, and has to merge their plans into the buyer's plan, the annuities must be preserved within in each purchased plan. Often this leads to multiple benefit structures within the merged plan which increases administrative complexity and cost. This makes it less attractive for the purchasing company and more difficult to administer, Clayton said.

McClain, of Mercer, said another issue is transparency of the costs. It is very difficult for plan sponsors to really understand what the costs are, especially in some of the delayed annuity vehicles where the cost is embedded in the investment, he said.

**Portability.** The lack of portability of annuities may be a problem. For example, if a participant invests in one of these delayed annuity vehicles, and then changes employers and pulls the money out of the investment, it is unclear what would happen, McClain said. The expenses that the participant paid for the annuitization would be lost. If the money is left in that annuity, the participant would be in multiple plans that would have to be tracked and managed. Another option is to take the balance to another plan and retain the annuitization part that has already been paid for, he said. These issues are administrative problems that have not been worked out yet, McClain said.

Brian H. Graff, executive director/chief executive officer of the American Society of Pension Professionals & Actuaries (ASPPA), told BNA Jan. 20 that since most people have multiple employers over time, buying pieces of annuities can present some challenges because annuities are meant to be funded over a long period of time. The value of an annuity is low if a participant only has it for a few years, he said.

**Fiduciary Liability.** Another reason annuities are not widely offered by employers is because it hard to offer them from a fiduciary perspective, Stephen Utkus, a principal with the Vanguard Center for Retirement Research, told BNA Jan. 22.

Whether to offer an annuity in a defined contribution plan is a nonfiduciary design decision. However, the purchase of an annuity as part of a plan is a fiduciary decision with possible consequences.

Toth said, "Fiduciaries' concerns lie with the fear of locking up funds for a lifetime with a single company." He suggested that fiduciaries acknowledge "that the task they undertake is different from the mere investment of account balances; the standard against which they will be judged has necessarily a stronger insolvency risk; and that they have addressed that risk adequately—in part—by understanding and relying upon the state's regulatory role in managing the risk. Fiduciaries can then further manage the risks by looking closely to the terms of the annuities being purchased."

A fiduciary concern is the risk of insurer insolvency. After the events of 2008, people are justifiably afraid of the insurance companies promising to pay out annuities. The insurance industry is regulated at a state level, but there is no federal agency similar to the FDIC for insurance, McClain said.

Toth said, "The best solution for the future is the proposal for a sort of FDIC program for plan annuities." This concept has also been discussed by academics and policymakers.

**Tax Reasons.** Regarding tax incentives, there is no legal or tax reason for buying annuities, Toth said. Amounts coming out of annuities are taxed the same as amounts coming out of the retirement plan.

Sherwin Kaplan, of Nixon Peabody LLP, Los Angeles, agreed that there is no tax advantage in annuities. The money builds up tax free, but since that money is already in a Section 401(k) plan, the tax deferral aspects are already present, he said.

## Annuity Products

The annuity market in the United States is underdeveloped, John said. However, there are many new products that have been and are being introduced.

Clayton said he hopes IRS will be flexible so employers who want to be more creative in allowing a Section 401(k) plan to have a benefit with an annuity-like feature will have the opportunity to do so. For example, there are some hybrid products that can be used with a defined contribution plan that have a promised rate of return, he said. In these new products, the plan pays an extra amount (the cost for the annuity-like feature), and the product guarantees some portion of return, such as 4 percent or 5 percent, regardless of what the market does. IRS ought to facilitate these hybrid products, Clayton said.

One problem with annuities is the loss of control, the fact that annuitizing is an irrevocable decision, McClain said. New products are trying to address this issue by adding a feature that lets an annuity owner take out

money or have a certain amount be guaranteed for heirs, he said.

Edward Ferrigno, vice president of Washington affairs at the Profit Sharing/401k Council of America (PSCA), told BNA Jan. 19, "Very few participants are interested in an all-or-nothing decision to purchase an immediate annuity contract before they have experienced retirement. The industry, in recognition of this problem, now offers many options that preserve principal for a set period of time, offer joint annuitants, allow partial annuitization directly within an investment product, etc. Most of these products are IRA-based in recognition that annuitization decisions are often delayed until participants have experienced and adjusted to retirement and that plan sponsors are reluctant to include annuities in their plans."

Another approach is to make annuitization the default payout option for defined contribution plans, as discussed in a white paper published by the American Council of Life Insurers in August 2009, *Automatic Lifetime Income as a Path to Retirement Income Security*. The paper lists three alternative approaches:

- immediate annuitization with a trial period, where retirees are defaulted into a two-year trial period of receiving monthly payments, after which they may elect an alternative distribution option or be defaulted into a permanent income distribution plan;
- laddered annuitization, where annuities are purchased with a retiree's account balance over five years, thereby decreasing the risk of investing all a retiree's money in an annuity at once; and
- in-plan annuity options, such as directing employer Section 401(k) matching contributions into deferred payout annuities rather than alternative investments, and allowing these options to count towards meeting automatic annuitization rules.

## The Demand for Annuities

Employers are reluctant to offer annuities as part of defined contribution plans, with the accompanying fiduciary and administrative issues, if participants are not asking for this option.

Ferrigno said, "A lack of demand is a major factor in determining the prevalence of annuities in plans. The second factor is the relative complexity of annuities and the fiduciary issues involved in having them in a plan."

A recent survey by the Investment Company Institute showed a majority of respondents were opposed to *mandated* annuities in Section 401(k) plans. "Americans do not support mandating the use of annuities for Section 401(k) accounts," Paul Schott Stevens, president and chief executive officer of ICI, said Jan. 8 (5 PBD, 1/11/10; 37 BPR 43, 1/12/10).

The ICI survey report, *Enduring Confidence in the 401(k) System: Investor Attitudes and Action*, found that "Americans soundly reject the idea that the government should mandate turning 401(k) assets into annuities," Stevens said. "Almost unanimously, the households in our survey agreed that retirees should be able to make their own decisions about how to mange their assets," Stevens said.

Stevens acknowledged that it is "difficult to get a clear read on public attitudes about annuities." However, he felt the survey offered a fair assessment on the annuity mandate issue. The survey found that 70 percent of households disagree with the idea of making retirees purchase an annuity with their assets, Stevens said. It did not make a difference to household respondents whether the annuity was from an insurance company (72 percent opposed) or from the government (71 percent opposed), he said. Opposition was even higher (more than 80 percent) among older, higher-income groups who are facing retirement, according to the survey report.

Jan Jacobson, senior counsel for retirement policy at the American Benefits Council, told BNA Jan. 21 that plan sponsors are not seeing a lot of participant interest in annuities. The concern from sponsors is that they will have complicated administrative work, while most participants just want their distributions, which are slowed down by the administrative process, she said.

There is growing interest in providing annuities as an option, but there is not as much demand as it needed, McClain said. Plan sponsors will not add options if there is no demand from participants, he said.

Utkus said in the Vanguard plans, sponsors have seen interest in retirement income and strategies for spending down participants' money. One of those strategies is annuitization, he said. There is a "steady drumbeat," and annuitization will be a growing theme, he said. However, most employers want to give a lump sum, and move on to their active workforce, he said. Furthermore, after five years, the vast majority of older participants that have retired have moved their money outside the plan, he added.

## What IRS Says About Annuities

IRS has issued two recent private letter rulings dealing with the issues surrounding annuitizing Section 401(k) plans.

Toth said PLR 200951039, dated Sept. 21, 2009, for the first time defines what an annuity really is for purposes of DC annuitization, and when the annuity election occurs.

PLR 200951039 clears up how to treat when a participant is making an annuity election and how to calculate the required minimum distribution (RMD), Toth said. These were two key elements to resolve from the tax compliance side, he added.

The PLR involves an annuity purchased by a defined contribution plan for distribution to participants, either from a group annuity contract held by the plan or as an individual annuity contract purchased by the plan and distributed to a participant.

According to Toth, the important parts of the PLR are that:

- Payments made from the contract after the account balance is shut down at a certain age are annuity payments. However, the payments made before that point are not annuity payments, but are periodic withdrawals that are considered RMDs up to the permitted RMD amount.
- Spousal consent is required at the time a participant elects distribution from an annuity. The annuity payments made after the period before the account balance is shut down (the access period) can be considered payments under a qualified joint and survivor annuity, even though the payments vary with investment performance, provided that the payments otherwise satisfy joint and survivor annuity requirements.
- The account balance during the payout time before it is an annuity is subject to the spousal consent rules on the naming of the beneficiary.

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■ The RMD for the payments during the access period will be determined using the account balance under standard defined contribution rules. However, after the account balance disappears and the payouts are considered annuities, the defined benefit method of computing the RMD will apply.

Toth said that the benefit of being treated as an annuity is that when the RMD is calculated, the payments meet the RMD rules.

The other PLR, released September 2009, PLR 200939018, is about longevity insurance. With a Section 401(k) balance, anyone can go buy a contingent annuity—for example, if someone wants to pay premiums when 65 for when they turn 85. Longevity insurance is an annuity contract, which is important for tax purposes. This PLR applies to retirement plans because the insurance is bought through retirement plans.

## What DOL Says About Annuities

Secretary of Labor Hilda Solis said on Dec. 7, as the Department of Labor released its Fall 2009 Regulatory Plan and agenda, that the department will be encouraging "employers to offer annuities as an option" for their Section 401(k) plans (232 PBD, 12/8/09; 36 BPR 2851, 12/15/09).

According to Jan. 20 comments by Phyllis C. Borzi, assistant secretary of labor of the Employee Benefits Security Administration, at the Los Angeles Benefits Conference, the Department of Labor, in conjunction with the U.S. Treasury Department, expects to issue soon a request for information (RFI) seeking input from the retirement plan community on lifetime income investment products and how such products may be used by plan sponsors and participants (12 PBD, 1/21/10; 37 BPR 195, 1/26/10).

The goal of the project is to solicit information from retirement plans and practitioners in a bid to start "a national dialogue" on lifetime income at a time when individuals are living longer, yet often fail to manage retirement fund payouts properly, Borzi said.

The RFI will contain a series of questions, with three basic themes:

■ what is happening in the market, not just with annuities, but other lifetime income options;

■ what (if any) legal, regulatory, or other reasons keep plan sponsors from offering plan participants lifetime income options in Section 401(k) type plans; and

■ why plan participants, even when offered such options in their retirement plans, often do not select them.

Once the data has been gathered, the agencies will then look at what might be done, perhaps through regulation or legislation, to improve access to, and use of, lifetime income opportunities by retirement plan participants, Borzi said.

## Annuity Disclosure Proposal in Congress

Legislation (S. 2832) introduced in the Senate on Dec. 3, would require plan sponsors of defined contribution plans, such as Section 401(k) plans, to inform plan participants on an annual basis of the projected monthly income they could anticipate receiving if they took distributions as annuities, based on the amount of money in their accounts (230 PBD, 12/4/09; 36 BPR 2766, 12/8/09).

The bill was introduced by Sen. Jeff Bingaman (D-N.M.) with Sens. Johnny Isakson (R-Ga.), and Herbert H. Kohl (D-Wis). Titled the Lifetime Income Disclosure Act, the bill would require an annual statement similar to what the Social Security Administration provides annually to individuals showing projected monthly payments based on current earnings, according to a release by Kohl's office. Defined contribution plans subject to ERISA "would be required annually to inform participants of how the account balance would translate into guaranteed monthly payments—based on age at retirement and other factors," the release said.

However, "to ensure there is no material burden or potential liability on employers who voluntarily sponsor [Section] 401(k) plans, the legislation directs the Department of Labor to issue tables that employers may use in calculating annuity equivalent, as well as a model disclosure," according to the release.

John said the Senate bill "is designed to start changing the way people think about retirement saving by exposing them to what income stream their savings will buy."

Ferrigno said, "PSCA does not support the Bingham bill in its present version. PSCA also does not support any of the other bills that offer preferential treatment for annuity investment payouts. This is a classic case where market intervention is unwarranted."

Graff said the Council of Independent 401(k) Recordkeepers, which is part of ASPPA, supports the bill. Giving participants that information will help them make better choices, he said. ASPPA does not support the idea of mandating that plans have annuities, he said. "But if we get more information out there and the industry develops different ideas, the marketplace will respond to that so the mandate won't be necessary," he said. If the demand is there, the marketplace will provide the products, he added.

## Government or the Marketplace

Another question surrounding the annuitization of defined contribution plans is whether government should get involved in encouraging this policy, or whether the marketplace should be allowed to take care of itself.

Iwry said Treasury was "reflecting the concern that has been expressed by many people that the marketplace might need at least some limited assistance, taking into account that people have accumulated retirement savings with the help of preferential tax treatment of retirement plans, which is intended to provide retirement security."

People seem to be looking for more help in managing the decumulation, Iwry said. "There has been concern expressed in the private sector, as well as among policy people, think tanks, and academics, that retirees are facing a daunting challenge in determining how to manage and use the money they have saved, including how quickly to spend it down in retirement," Iwry said.

There is a growing interest within the pension and retirement savings community in tackling this problem, Iwry said. Government shares the perception that there is room to help people with their decumulation issues and there seems to be a desire in the market for some form of assistance from the government, he said.

Jeffrey Brown, the Karnes Professor of Finance at the University of Illinois and author of the ACLI white pa-

per *Automatic Lifetime Income as a Path to Retirement Income Security*, told BNA Jan. 21 that "we should let the market rather than the government determine what products are best. Having said this, we would be fooling ourselves to think that government regulation in general—and rules governing fiduciary responsibilities in particular—do not already have an enormous impact on how 401(k) plans are designed and how plan sponsors behave. Today, we have a system in place that 'discourages' annuitization and implicitly promotes lump-sum or phased withdrawal options that take no account of concerns about outliving one's resources. Examples include the fact that for many years, plan sponsors exposed themselves to increased fiduciary risk by providing income options to employees, and less risk if they just let employees take a lump sum. Another example is that Congress imposes minimum distribution rules that implicitly encourage people to consume their savings more quickly, rather than less quickly. At minimum, we should get the government out of the business of discouraging annuitization. As for going further and encouraging it, I am okay with this so long as people always have the freedom to opt out if an annuity is not right for them."

Clayton cautioned, "We killed DB plans in part by making them more expensive to administer and less flexible to fund. If we start making 401(k) plans complex like DB plans, with the same kind of expense and funding factors, then employers may bag them."

Clayton added that policymakers are pushing annuitization of defined contribution plans for several reasons: first, some people are not good managers of their money; second, government is concerned that baby boomers will outlive their Section 401(k) retirement accounts; third, making money last a lifetime takes planning, discipline and a fairly sophisticated analysis for life expectancy and rate of return—most plan participants lack the ability to do this; and fourth insurance companies controlled a larger part of the market when annuity benefit products were more common. Insurance companies have plenty of political clout and would like to move the market more towards products in which they have an edge, he said.

## The Future of Annuities

The discussion about annuities is intertwined with the discussion of ensuring a stream of lifetime income in general. The government is in the information-gathering stage, while the marketplace is introducing products that may appease some participants and plans sponsors' worries about offering annuities in their defined contribution plans.

John said there is a growing interest in annuitizing 401(k) plans from administrators, employers, and insurance companies, although he does not anticipate any form of a mandatory annuitization. However, he expects and hopes to see something along the lines of the Senate proposal get serious consideration. John said he did not anticipate any substantive any policy proposals until 2011 or 2012. Although this issue is definitely on the horizon and will be discussed, it is in the early stage of collecting information and making decisions about where to go, he said.

Kaplan told BNA that participants need a new kind of product, that can guarantee a lifetime income stream without being insurance. At this time, annuities can only be sold by insurance companies, he said. Kaplan proposed amending ERISA to allow other entities besides insurance companies, such as mutual fund companies or investment advisory groups, to sell annuities. This would allow asset pooling that would reduce cost. If there is a large enough group of people, fairly accurate predictions on mortality can be made, he said.

Graff said, "We need to be thinking in terms of promoting secure lifetime income, and less about products to achieve that."

McClain, from a practical point of view, said that whether an annuity in a Section 401(k) plan is a good idea depends on the company's work force. For example, a hi-tech company with a young workforce probably should not worry about annuitizing at this point. However, a company that has an older work force that has been investing in Section 401(k) plans for 20 years may have a bigger incentive to add an annuity option to their plan. McClain said that he would encourage plan sponsors to at least start becoming educated about annuities, and research the issues and products.

By Andrea L. Ben-Yosef

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