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Reducing regulatory obstacles to annuities in 401(k) plans

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Retirement Security Project at BROOKINGS

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers. Nearly half of all workers do not have access to an employer-sponsored retirement savings plan or a traditional pension. Among workers who do have access to such a plan, the shift from defined benefit pension plans to defined contribution plans makes it even more important for individuals to save for their own retirement. To address these trends, RSP proposes research-based policy solutions aimed at helping middle- and low-income Americans to better prepare for a financially

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The secular shift from defined benefit (DB) plans to retirement saving accounts like 401(k)s and IRAs creates different and increased risks and retirement planning tasks for individuals. Unlike in DB plans, workers who participate in 401(k)s and IRAs are responsible for making choices during the accumulation stage as well as during the decumulation stage. The rise in automatic features has mitigated these concerns for many workers during accumulation, but not during decumulation. Retirees face a key dilemma as they consume their retirement resources: how to manage the risk of outliving their savings without unnecessarily sacrificing their standard of living. Commercial income annuities sold by insurance companies can provide a key source of lifetime income. Even though income annuities appear to have significant potential to improve retirees' well-being, the market for such products has proven small to date.

This policy brief summarizes legislative and regulatory changes to encourage 401(k) and other defined contribution (DC) plan sponsors to offer annuities as retirement income options and to encourage workers to select them.

I. Background

A life annuity is a financial product or contract (a) offered by an insurance company and issued to an owner, in which (b) the owner makes one or more payments to the company and (c) at a specified later date, the company initiates regular payments to the owner that last for the duration of the owner's life. Annuities vary in many ways around this basic structure. Fixed income annuities, promising to convert a sum of money into a predictable income stream for life, tend to be relatively straightforward. Other forms of annuities are designed as tax-favored investment products oriented mainly toward asset accumulation. These assets depart from the role of annuities highlighted in this brief: protecting against longevity risk and providing guaranteed lifetime income in retirement.

Economic theory shows that life annuities can increase individual welfare by balancing the risk associated with lifespan uncertainty and the risk associated with unnecessary reduction in living standards. Despite the theoretical advantages of annuities, less than 2 percent of all U.S. retirement assets are held as fixed annuity reserves.

Why the retirement income annuity market is not larger is a key question for policymakers and researchers. Numerous factors limit annuity participation, including the fact that Americans already own annuitized wealth through Social Security and (effectively) Medicare, that annuities are often expensive (or are perceived as such) relative to actuarially fair instruments, and that income annuities generally need to be illiquid. Behavioral research has identified additional factors. Many people feel uncomfortable spending a large sum to purchase what appears in comparison to be small payments; another common concern is financial loss in the event of death soon after purchasing the annuity ("What if I get hit by a bus tomorrow?").

Negative press coverage, reputational issues, and related factors have also affected consumers' perceptions and demand. While problematic product designs and sales practices for some types of annuities are also a factor, they should not obscure the fact that straightforward and competitively priced commercial income annuities can play an important, pro-consumer role in retirement planning.

II. Fiduciary Liability

Perhaps the most salient regulatory impediment to greater utilization of annuities to provide retirement income from employer-sponsored plans is plan sponsors' fear of long-term fiduciary liability for selecting an insurer that ultimately fails to meet its obligations. We recommend mitigating the risk of liability by enacting an appropriate statutory fiduciary safe harbor for DC plan fiduciaries who select annuity providers that are highly qualified (highly rated for financial strength). We also recommend exploring the need for a "universal" independent fiduciary.

Plan sponsors fear potential long-term fiduciary liability for violating the Employee Retirement Income Security Act of 1974 (ERISA)'s high standard of prudence when selecting and retaining annuity providers. These and other considerations have discouraged many 401(k) plan sponsors from offering annuities.

Department of Labor (DoL) regulations describe a series of steps fiduciaries must take to ensure that they satisfy ERISA's prudence requirement when selecting an annuity provider. The regulations appear to require employers to make determinations of insurance companies' long-term financial strength that are beyond most employers' reasonable capacity, although they call upon employers to consider retaining an independent expert to advise them. They also require fiduciaries to "appropriately consider" insurer financial capability and cost, and to "appropriately conclude" that the insurer is in fact financially capable and that costs are in fact reasonable. The use of the term "appropriately" leaves fiduciaries uncertain whether they have complied. Accordingly, these regulations are not sufficiently objective to satisfy plan sponsors' desire for a safe harbor in the traditional sense, i.e., a simplifying decision rule or process specifying definitive, objective, readily ascertainable steps fiduciaries can follow to be sure they have "checked the box" and will be deemed to have acted prudently in selecting an annuity provider.

As an alternative to these regulations, the insurance industry has proposed a simple, straightforward, and objective statutory safe harbor that is one of many provisions included in recent legislative proposals like the Retirement Enhancement and Savings Act and SECURE Act. The pending legislative version, however, has no financial strength standard. It does not even favor financially stronger providers; instead, it grants the same stamp of approval to virtually any annuity provider that has been licensed to do business for seven years. This falls short in protecting retirees, protecting and giving confidence to plan sponsors, and remaining true to the policy underlying ERISA's high fiduciary standards.

Our recommended safe harbor would be unambiguously limited to selection of the annuity provider based on its financial strength and stability; it would not apply to fiduciaries' decisions regarding the type, price, or other terms of annuity contracts. Those decisions would continue to be subject to ERISA's regular fiduciary standards, but the safe harbor would streamline the full fiduciary analysis normally required to prudently select an insurer. It would enable plan fiduciaries to rely on appropriate third-party factual information (though often transmitted through insurer representations) regarding the insurer's financial capability

We recommend that a fiduciary safe harbor include a meaningful quality standard—expressed through simple, objective indicators—relating to insurers' financial strength.

Since the market and ERISA fiduciary analysis cannot and do not turn a blind eye to relative claims-paying ability, neither should an ERISA safe harbor.

A meaningful standard of quality would maximize the likelihood that benefit promises will be backed by insurers with the greatest claims-paying capacity. Accordingly, our proposed safe harbor would be limited to insurers that are very strong financially (not necessarily "the safest available" annuity in the market, but among the safest). To be workable, the safe harbor would streamline the process of distinguishing among annuity providers based on financial strength (or claims-paying ability) with reference to the financial strength ratings assigned by the leading Nationally Recognized Statistical Rating Organizations (NRSROs), which are registered with the Securities and Exchange Commission (SEC) and which it oversees and examines. Our proposed inclusion of a high financial strength standard is in no way limited to a plan's selection of a single annuity provider. It is equally applicable when a plan selects multiple providers or gives participants access to an annuity quotation and purchase platform.

Whatever the format, the annuity market generally does not consider merely whether an insurer is licensed but shows considerable demand for NRSRO insurer financial strength ratings. To be sure, these NRSROs have come in for sharp criticism based on their lack of independence and dramatic overrating of mortgage-backed securities contributing to the Great Recession. Since then, efforts have been made to improve rating agency practices, including increased SEC oversight pursuant to the Dodd-Frank legislation. Put simply, the issue is not whether financial strength ratings are fallible, but whether on net they would add value to a safe harbor. Recognizing the ratings as a potentially useful resource, an annuity provider in good standing with state regulators would qualify under the safe harbor only if it has sufficient experience in providing annuities and in recent years has had consistently high financial strength ratings from the major national NRSROs -- for example financial strength ratings by at least two of the four major NRSROs that are in their top few ratings categories, and no lower ratings. Because each NRSRO has its unique scale of rating categories and letter ratings, without alignment or correspondence among them, Congress could direct DoL, in consultation with Treasury, and perhaps other neutral experts, to specify roughly comparable thresholds for each NRSRO or a composite threshold, and otherwise fine-tune the financial strength ratings standards.[1]

ERISA's fiduciary standards typically look to each plan sponsor to engage its own expert consultant or independent fiduciary to assess each insurer's long-term financial strength. This is unnecessary and inefficient. As a possible eventual alternative to NRSRO financial strength ratings as a key element of a safe harbor, a strictly independent, expert, non-profit entity might perform this analysis for all plans. For example, DoL could assist in establishing or certifying such an expert entity to serve as a kind of universal independent fiduciary to advise solely on the financial strength of annuity providers for ERISA purposes. Alternatively, the responsibility could be delegated to one or more existing government agencies, respected professional organizations, or other non-profit entities, which might set up a panel of independent experts with a dedicated staff that might include detailees from NRSROs.

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[1] As discussed in our accompanying paper, the COMDEX composite rankings are one example regulators could take into account.

The independent board or panel could in some measure rely upon NRSRO ratings in arriving at its own independent conclusions (and might even contract with NRSROs to have them rate insurers' financial strength using special procedures under the independent entity's supervision). Ratings would not be funded or controlled by insurance companies. Instead, the independent board, which might be publicly funded, would determine which annuity providers it rates for this purpose, taking into account plan sponsor requests. It would not be a guarantor. Its ratings or other determinations would not be binding on plans (but would carry considerable weight and might even be determinative in a safe harbor context), and its personnel would be protected from liability.

III. Annuity Portability

The limited portability of annuities is a second key regulatory concern. A plan sponsor that discontinues offering an in-plan annuity in which contributions have been invested interrupts the steady accumulation of annuity benefits. Contributions stop, and employees may be subjected to annuity liquidation or surrender fees, unless they move the annuity to another plan or IRA. However, because the law generally prohibits current employees from making such a distribution, we propose a legislative exception to the 401(k) plan withdrawal restrictions to allow current employees to withdraw and directly roll over an in-plan annuity to an IRA or another employer plan that would accept it.

IV. Required Minimum Distribution (RMD) Rules

RMD rules generally require participants in most tax-qualified retirement plans and IRAs to begin withdrawing assets beginning after they reach age 70 ½. The regulations require that benefits be distributed over the participant's life or life expectancy, or more rapidly. The rules are not designed to serve as guidelines for optimal asset decumulation. Indeed, the regular RMD pattern does not match most retirees' needs or desires. In addition, the rules are poorly targeted. They are intended chiefly to ensure that tax-advantaged retirement benefits are used to increase financial security in retirement rather than for estate planning. This legitimate goal is not efficiently advanced by taxing ordinary retirees' savings or subjecting ordinary retirees in their 70s, 80s, or 90s to the current 50 percent excise tax if they fail to make the prescribed withdrawals.

Accordingly, we propose to completely and permanently exempt from RMDs all retirees with average or below-average retirement balances. The maximum aggregate balance (qualified plans and IRAs) qualifying for the exemption would be $100,000 as of age 70 (phasing out ratably over the next $10,000) with a view to exempting a majority of retirees. However, this RMD dollar threshold should be adjusted upward (not to exceed $250,000) – or, if necessary, downward – depending on the affordability of the estimated revenue cost.

We propose to offset the revenue cost of this exemption by closing a sizable gap in the RMD regime. Wealthy retirees can currently defer and reduce taxes by leaving their retirement savings to be paid after their death to young heirs over the heirs' entire life expectancies. Instead, we would generally require distribution to be completed within five years after the retiree's death. We also recommend regular updating of the RMD life expectancy tables, requiring IRA trustees to automatically calculate RMDs for IRA owners, simplifying and harmonizing Roth and traditional IRA age 70 ½ distribution and contribution rules, and clarifying that the RMD rules do not permit DB sponsors to buy back ongoing DB plan life annuities.

V. Conclusion

Promoting appropriate annuity options in 401(k) and other DC plans is a challenge worth taking on. Greater use of income annuities promises to increase retirement security and provide meaningful help in addressing retirees' decumulation dilemma. DC plans could begin to offer lifetime income to tens of millions of participants, with group purchasing, institutional pricing, economies of scale, and behavioral strategies. To that end, we propose policy reforms to establish an appropriately worker-protective fiduciary safe harbor for the selection of annuity providers, increase annuity portability, and reform the RMD regime.[2] These changes would provide an important start toward restoring the pension to our private pension system.

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[2] For further development of and detail on all the points in this policy brief, see our accompanying paper, "When Income Is the Outcome: Reducing Regulatory Obstacles to Annuities in 401(k) Plans."

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