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Retirement Income Solutions: The Next Big Thing?

Insurers and investment manages are touting their retirement income wares, but plan sponsors should think carefully before they add these products to their plans.

By Lori Lucas

Insurance companies and investment managers are betting that retirement income products (commonly known as in-plan annuities) are the next big thing in defined-contribution plans. In the past several years, product development in this arena has flourished, creating a myriad of different solutions for guaranteeing income in retirement through DC plans.

In a recent Employee Benefit Research Institute Policy Forum, half a dozen retirement income products were discussed, each with vastly different features. Some had guaranteed minimum withdrawal benefits tied to the growth of a target-date fund. Others allowed participants to lock in a stream of income (or minimum future income) for retirement through DC plan contributions. So are retirement income solutions ready to become a fixture in DC plans? Not just yet.

Let's take the example of a product that provides guaranteed minimum withdrawals and has a target-date fund as its underlying investment. A typical product of this type might assume a certain annual growth rate, such as 5 percent. If the actual market value of the account exceeds this rate, the participant can lock in the upside when the account is periodically recalculated (usually annually, on a random date such as the participant's birthday). This is known as a "high-water mark."

Now, say a participant investing in such a product was lucky enough to celebrate his/her birthday on September 28, 2007, "locking in" the account value when the Dow Jones industrial average was at 13,913—a very high-water mark indeed. As long as this participant keeps the money in the product, he/she would have a value guaranteed by the insurer to be at least the amount that was in the plan on September 28, 2007, from which to draw income in retirement. Further, if the account value were ever to be exhausted in retirement, the insurance company would guarantee that income (under certain conditions).

This certainly sounds attractive. And yet plan sponsors are not rushing to add such products—or any retirement income solutions products—to the fund lineup. In fact, in a recent Callan survey, just 7 percent of plan sponsors said they were very likely to add an in-plan annuity in 2009.

There are a number of good reasons for hesitation.

Insurance risk is a big one. Will the insurer be able to make good on its promises? And if not, is the plan sponsor then responsible? This is a subject of some controversy. Variable annuities were allowed as a "qualified default investment alternative" in the Pension Protection Act, which may provide some fiduciary comfort.

Further, annuities in general are enjoying a degree of support in Washington. Reps. Earl Pomeroy, D-North Dakota, and Ginny Brown-Waite, R-Florida, recently introduced the Retirement Security Needs Lifetime Pay Act, which provides a tax incentive for workers to annuitize part of their retirement savings. Meanwhile, Mark Iwry, recently appointed senior advi-

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sor at the Treasury Department, has been a supporter of defaulting DC participant balances into annuities at retirement.

There is also speculation that the distribution annuity safe harbor within the Pension Protection Act of 2006 will be explicitly applied to in-plan annuities. This safe harbor provides plan fiduciaries with guidelines to follow when selecting annuity providers and contracts. However, the guidelines were written for distribution annuities, not in-plan annuities.

In sum, while there appears to be fiduciary relief on the horizon, today plan sponsors may not be comfortable with their fiduciary role with respect to retirement income products.

Portability is another issue. What actions can be taken if the insurer's fortunes do take a turn for the worst? Keep in mind, in the example above, that the ability to draw down from the high-water mark is possible only so long as the individual keeps his/her money in the annuity. If the plan sponsor determines that this guaranteed minimum withdrawal benefit product is no longer prudent to offer, it would be very difficult to remove it from the plan and map participants into another option, as that would eliminate participants' guarantees.

The plan sponsor could "freeze" the annuity, allowing no additional contributions. However, leaving a frozen impaired annuity in the plan might again raise the specter of fiduciary risk to the plan sponsor.

Portability also becomes a thorny issue in the event of a change in record keepers. In-plan annuity providers have sought broad support by record keepers, but with varying degrees of success. If a record keeper that is otherwise a good fit for a plan cannot support the existing retirement income product within the plan, this again could pose a fiduciary quandary for the plan sponsor. It becomes an issue of the tail wagging the dog if the plan sponsor is forced to choose a record keeper because it supports the in-plan annuity provider—but is not otherwise suitable for the plan.

Finally, on the portability front, there's the issue of when a participant terminates employment prior to retirement. In a number of situations, an individual-retirement-account vehicle might be available that could accommodate the participant's in-plan annuity account. Alternatively, the participant could leave the money in the plan. Yet this latter option may not be attractive to plan sponsors, especially in the case of small participant balances.

Retirement income products also struggle with cost and participant communication. Some in-plan annuity providers report that since the market crisis, insurance costs of their products have increased by two or more times. Plan sponsors might certainly wince at insurance expenses that are well north of 100 basis points.

From a communication perspective, the plan sponsor certainly would not want participants to transfer in and out of retirement income products without understanding that they are paying for certain guarantees—and giving up those guarantees when they transfer out of the fund.

Innovations among providers of these products abound. These include the use of multiple insurers to diversify insurance risk and cooperative efforts between providers and record keepers to improve portability. Further, as mentioned, there is activity in Washington to make annuities more attractive to plan sponsors and to individuals.

This latter point should not be understated. One final obstacle for plan sponsors in adding in-plan annuities is lack of participant demand. Annuity utilization rates are notoriously low. A Hewitt Associates survey found that when annuities are offered as a distribution option, only 3 percent of participants elect it. Participants do not use annuities for a variety of reasons, not the least of which is a desire to maintain control of their assets and a lack of trust in insurance companies. As one retiree said in a Society of Actuaries focus group: "Well, my husband has poor health, so I don't think he's going to live a long time. And I think I can do better than [insurance companies] can do."

All of this says that it is still early days for retirement income solutions in DC plans—but that these products certainly merit continued interest by plan sponsors and by legislators as well.

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