DC In-Plan Retirement Income Solutions — Are We There Yet?

Part 2: Considerations of Offering Retirement Income Solutions in the Plan

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Note: For Part 1 of this overview article, please see the Winter 2017 issue of Defined Contribution Insights.

There are significant benefits to participants having a retirement income solution offered within their workplace retirement plan. Together, these benefits are expected to improve all around retirement readiness, as they help fill the void left by disappearing defined benefit plans. Fostering retirement readiness is not only a heavily discussed topic for plan sponsors, but for policymakers as well. Benefits to participants include:

- **Informed evaluation of products and prudent selection:** selecting a suitable retirement income vehicle can be a confusing and overwhelming proposition to most individual investors. There are a multitude of products available, each with its own set of complex tradeoffs. Having a professional help evaluate products and identify the tradeoffs is a significant benefit to participants.
- **Reduced costs:** the costs for the products are generally significantly lower when offered at the institutional level than they are when purchased in the retail market.
- **Higher utilization:** when offered in the plan, utilization is believed to be higher.
- **Increased participant savings:** many believe that in-plan solutions lead to better savings behavior during the accumulation phase.

In addition to the paternalistic motives of fostering the retirement readiness of participants, there are several other reasons why plan sponsors would want to offer an in-plan retirement income solution. Such reasons include:

- To retain assets in the plan, which lowers administrative costs.
- To foster graceful workforce succession, by helping older employees retire, which in turn may reduce the cost of providing health care benefits to employees.
- To enhance the brand of the employer — by offering attractive retirement benefits, the company may be better able to attract and retain talent.

However, while there are benefits, the barriers and considerations to plan sponsors' adoption of an in-plan solution are many and formidable, particularly for products with income guarantees. Such barriers include:

- The fiduciary burden of selecting and monitoring insurance-based products.
- While there is regulatory guidance pertaining to the selection of annuities as distribution vehicles in defined contribution plans (which will be discussed in the next section), plan fiduciaries are still apprehensive about the perceived uncertainties associated with prudently evaluating these insurance-based products.
- Fear of litigation risk, especially if product guarantees are breached.
- Administrative complexities.
- Constraints on portability: a plan's current recordkeeper may not be able to accommodate a preferred annuity-based or blended solution, necessitating an unwanted change in recordkeeper.
- Additional cost to the plan.
- Burden of additional communications and participant education.
- Lack of utilization and demand of annuity products: while participants may say they like the idea of a guaranteed income solution, they actually remain reluctant to use them.

Plan Sponsor Fiduciary Obligations with Guaranteed Retirement Income Solutions and Current Regulatory Environment

The fiduciary burden and perceived risks associated with adding guaranteed retirement income solutions to a retirement plan are the most significant barrier for plan sponsors. According to the MetLife Retirement Practices Study (2012), 79 percent of plan sponsors indicated that the fiduciary liability concerns are discouraging them from offering annuity-based solutions within their defined contribution plan.

Responding to a statutory mandate, the Department of Labor (DOL) issued new rules intended to make

annuities a more appealing benefit distribution option for 401(k) and other defined contribution plans. However, the Pension Protection Act ("PPA") of 2006 (P.L. 109-280) directed the DOL to amend its guidance to clarify the "safest annuity available" rule does not apply to defined contribution plans.

In 2008, the DOL finalized a rule (73FR58447; *Selection of Annuity Providers — Safe Harbor for Individual Account Plans)* that addresses a defined contribution plan's fiduciary obligations in selecting annuity providers. It is important to note that the rule applies to plan fiduciaries as they evaluate annuities to serve in a benefits distribution capacity only. While there is currently no specific guidance that pertains to the evaluation and selection of products with an annuity feature that serve as vehicles of asset accumulation and benefits distribution — such as Guaranteed Lifetime Withdrawal Benefits (GLWBs) — some contend that the rule can prudently be extrapolated to blended products like GLWBs.

The rule describes the following five-step process by which defined contribution plan fiduciaries can satisfy ERISA fiduciary standards when selecting an annuity provider for benefits distribution: § 2550.404a-4 Selection of annuity providers — safe harbor for individual account plans.

(a) Scope.

(1) This section establishes a safe harbor for satisfying the fiduciary duties under section 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974 (ERISA), 29U.S.C. 1104-1114, in selecting an annuity provider and contract for benefit distributions from an individual account plan. For guidance concerning the selection of an annuity provider for defined benefit plans see 29 CFR 2509.95-1.

(2) This section sets forth an optional means for satisfying the fiduciary responsibilities under section 404(a)(1)(B) of ERISA with respect to the selection of an annuity provider or contract for benefit distributions. This section does not establish minimum requirements or the exclusive means for satisfying these responsibilities.

(b) Safe harbor. The selection of an annuity provider for benefit distributions from an individual account plan satisfies the requirements of section 404(a)(1)(B) of ERISA if the fiduciary:

(1) Engages in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;

(2) Appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract;

(3) Appropriately considers the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract;

(4) Appropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract; and

(5) If necessary, consults with an appropriate expert or experts for purposes of compliance with the provisions of this paragraph (b).

(c) Time of selection. For purposes of paragraph (b) of this section, the "time of selection" may be either:

(1) The time that the annuity provider and contract are selected for distribution of benefits to a specific participant or beneficiary; or

(2) The time that the annuity provider is selected to provide annuity contracts at future dates to participants or beneficiaries, provided that the selecting fiduciary periodically reviews the continuing appropriateness of the conclusion described in paragraph (b)(4) of this section, taking into account the factors described in paragraphs (b)(2), (3) and (5) of this section. For purposes of this paragraph (c)(2), a fiduciary is not required to review the appropriateness of this conclusion with respect to any annuity contract purchased for any specific participant or beneficiary.

For most plan sponsors who are considering adding an insurance-based product to their plan, the fourth step presents a potentially problematic issue. Because of the long-term nature of the guaranteed payout, fiduciaries

are expected to prudently evaluate the claims-paying ability of the insurance company for decades into the future. This is confirmed by the MetLife 2016 Lifetime Income Poll which revealed that 76 percent of respondents say that in determining the adequacy of the solvency of a potential annuity provider for their DC plan, they would prefer to be permitted to rely on certifications from the annuity provider based on the regulatory process carried out by a state insurance commissioner, rather than to conduct the solvency due diligence process themselves as part of their regular due diligence process for plan sponsors.

Plan sponsors fear that the requirement to assess the future strength of an insurance company and the lack of exact guidance on how the assessment should be made may heighten litigation risk should an insurance company become unable to fulfill its obligations in the future. One of the biggest lessons learned from the 2008–2009 financial crisis was that big insurance companies can fail. While the US taxpayers bailed out failing insurance companies in the crisis, it is far from clear that this established a reliable precedent going forward.

Recent Developments

In July 2015, the Department of Labor issued a Field Assistance Bulletin (FAB 2015-02) that included additional guidance that fiduciaries need only monitor an annuity provider until the annuity is no longer offered. For this purpose, the Safe Harbor Rule provides that "the time of selection" means:

1. the time that the annuity provider and contract are selected for distribution of benefits to a specific participant or beneficiary; or
2. the time that the annuity provider is selected to provide annuities as a distribution option for participants or beneficiaries to choose at future dates.

The Safe Harbor Rule also provides that when an annuity provider is selected to offer annuities that participants may later choose as a distribution option, the fiduciary must periodically review the continuing appropriateness of the conclusion that the annuity provider is financially able to make all future payments under the annuity contract, as well as the reasonableness of the cost of the contract in relation to the benefits and services to be provided. The fiduciary is not, however, required to review the appropriateness of its conclusions with respect to an annuity contract purchased for any specific participant or beneficiary.

This helps to clarify that should a plan sponsor choose to offer an annuity and then replace providers down the road, the sponsor is only liable for monitoring the currently offered annuity, and not the discontinued annuity. This does not remove all of the burden for selecting and monitoring an annuity provider, but does lessen the concern that if there was to be an issue with an annuity provider and it was no longer offered as a distribution option.

On July 1, 2014, the US Department of Treasury and the IRS issued a final regulation pertaining to the purchase of longevity annuities by participants in qualified retirement plans (including IRAs).

The regulation makes it easier for retirees to utilize longevity annuities as part of a retirement income planning strategy. The new rules also may make it easier for insurance companies to construct in-plan solutions that utilize longevity annuities. Under the stipulations of the new regulation, the Required Minimum Distribution (RMD) rules were altered so that the value of a Qualifying Longevity Annuity Contract (QLAC) is excluded from the participant's account balance when determining the participant's annual RMD. The regulation allows a participant to purchase a QLAC with the lesser of 25 percent of his/her balance or $125,000. The amount used to purchase the QLAC will reduce the account balance subject to the required minimum distribution rules.

In a press release from the Department of Treasury on July 1, 2014, the following interpretation was offered:

> *"These final rules make longevity annuities accessible to qualified plans by amending RMD so that longevity annuity payments will not need to begin prematurely in order to comply with those regulations. This change will make it easier for retirees to consider lifetime income options: instead of having to devote all of their account balance to annuities, retirees who wish to follow a combination strategy that uses a portion of their savings to purchase guaranteed income for life while retaining other savings in a more liquid or flexible investment will be able to do so."*

While the fiduciary issues associated with selecting an annuity-based or blended in-plan solution would also apply to longevity annuities (or blended products that incorporate longevity annuities), and the small number of recordkeeping platforms that can accommodate these products still remains problematic, there are several key benefits to an in-plan solution that incorporates longevity annuity contracts. Longevity annuity contracts are typically less expensive to purchase than immediate annuities due to the shorter-term nature of the product. Another benefit to longevity annuity solutions is the tax impact. With revised RMD rules, there is an element of tax deferral. By excluding the value of the longevity annuity contract from RMD calculations, the participants can defer taxes on that money until they are 85 years old. The lower costs of longevity annuity contracts, combined by a tax benefit, may make them more attractive to participants.

In October 2014, the DOL issued notice 2014-66, which acknowledged that lifetime income products could be used as part of a target date strategy offered by a plan. Allowing target date

managers to include lifetime income products, such as annuities, creates another resource for plan sponsors, and therefore participants, to access these vehicles, as well as provides another level of vetting of the product — that of the target date manager. There are now a few products that include annuities in their design, as well as a few investment managers that are including the concept of annuities in their construction of a glide path. For example, one target date manager has designed a glide path that would gradually build up an allocation of 25 percent of assets at the retirement date to the purchase of a deferred annuity. While the design is such that the purchase must be made outside of the plan, this may prompt additional target date providers to consider making similar changes or incorporating annuities into their product construction.

As discussed earlier, utilization of annuity-based solutions is currently very low. As such, it is not surprising that non-insurance company recordkeepers have not been particularly motivated to accommodate products that incorporate annuities. However, should there be products that are more attractive to participants, resulting in an increase in the demand and utilization of products that incorporate annuities, recordkeepers would be incentivized to take steps to accommodate them, not wanting to cede a potentially large market to insurance companies. Increased utilization may also hasten the evolution of industry-accepted guidance for plan fiduciaries in evaluating the claims paying ability of insurance companies, even without explicit and specific guidance from the DOL, thus increasing the comfort level of plan fiduciaries to offer such products as an in-plan solution.

Conclusions

There is little doubt the diminished role that defined benefit plans now play in the retirement planning of the American workforce has left a void in the retirement income equation. As most of today's defined contribution plans are primarily designed as vehicles for the accumulation of retirement savings, employees who previously had access to defined benefit plans have lost the ability to translate their retirement savings into an income stream for retirement and employees that never had that access in the first place are left looking for a solution to meet their retirement spending needs with confidence.

Without an in-plan retirement income product, these employees are, at best, compelled to purchase income solutions on their own, at costly retail prices. At worst, these employees make uninformed, expensive and poor investment choices. With the retirement of the baby boomer generation upon us, the problem is magnified. As we have explored and are looking to answer the question of "are we there yet," we are close but not quite. The government and the retirement plan industry are hard at work solving the retirement income crisis that faces us today by refining regulations and creating products for DC plans to embrace. PSCA will continually monitor, evaluate, and inform its members of all developments around this thorny issue and hopefully one day we can say "we are here, we made it!".

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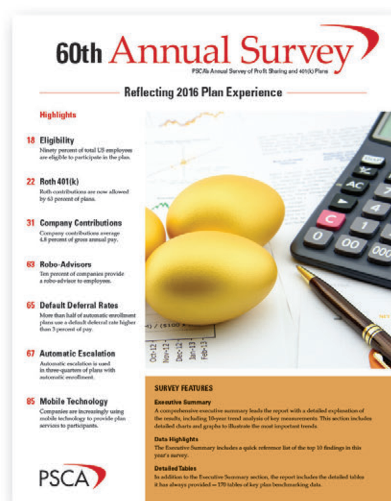
PSCA's 60th Annual Survey of Profit Sharing and 401(k) Plans



PSCA's Annual Survey provides the most comprehensive, unbiased DC plan benchmarking data. Does your plan offer Roth? Sixty-three percent of plans do. Does your plan use automatic escalation to help employees save more? Three-fourths of plans do. Find out what other plans are doing to ensure your plan remains a competitive, best-in-class benefit.

Data includes but is not limited to:

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