Annuities and Institutional Best Practices: A Good Fit

Could it become a future breach if DC plans don't at least consider them?

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The importance of managing longevity risk can no longer be ignored by defined contribution plans - the SECURE Act incorporates annuities into fiduciary prudent process.

Sponsors will likely want to dedicate both time and resources in the future to conduct expert-level due diligence on the complex spectrum of mortality pooled solutions. They may decide to do so for compassionate reasons. Another motivation could be their fiduciary duty to investigate.

Qualified experts are needed to help sponsors evaluate "The Why" in a way that is well thought out, easily communicated, and documented. When contemplating in-plan solutions this year and next, Trustees are unlikely to succeed initially without new education – perhaps accompanied by unbiased guidance on ways soon-to-be retiring employees can safely access annuities outside the plan.

The Pension Protection Act of 2006 codified a sea change idea for defined benefit plans: that a portfolio of stocks and bonds is a poor match for funding essential expenses. For defined contribution plans, an objective advisor should be able to explain the differences between annuity solutions as alternatives to systematic withdrawal strategies that can fail.

Financial markets uncovered risks inside balanced and target date funds in 2022 that were dormant for many years. This has created stress for all participants and especially for those closest to retirement. For older employees nearing retirement, the emphasis for plan education best practices should be on what happens in their income phase and how to safely decumulate.

Sponsors who are not yet sure they want to consider annuities inside their plans could consider supplying objective participant education this year on how to safely access immediate annuity options in the private market. Several platforms are now available for them to "comparison shop" - employees could benefit from guidance about what to look for, and why. This could help clarify what they are seeing in their statements as the lifetime income illustration.

The priority for the older participants -- and the plan trustees who serve them -- should be to distinguish between annuities that provide income-only versus those designed to support accumulation first and income second. Many trustees should not try to broach this subject on their own. Advisors are needed to provide the same kind of leadership and guidance that they would for any complex area.

A good place to start is the Department of Labor's intended safe harbor for lifetime income illustrations on statements. How many sponsors currently understand the term "mortality pooling" and know why the DOL considers it prudent? Can they explain it to their participants?

At a minimum, a meeting should be held to make an intentional decision about whether to research annuity options, with the rationale for a "probably not," "In the near term," or "in the future" investigation documented. This first meeting will most likely need guidance; the array of options is complex, and achieving an institutional due diligence standard will require consideration of multiple factors. A few will be quantitative and relatively easy to do, while many more will be qualitative -- and much more difficult. Given the structure of the annuity marketplace this will require an experienced and unbiased point of view.

To begin, a guide to prudent annuity due diligence is published in the new ERISA Section 404(e). It includes the words "objective, thorough and analytical."

Objective : Where will sponsors find unbiased expertise? Insurance and mutual fund companies can provide information about their specific solutions but are not likely to meet a test for either thoroughness or objectivity (profit margins vary by product for those who issue them).

Biases may also exist in the retail advice market. Significantly higher commissions are paid to incentivize insurance agents to sell the higher profit margin products, while Registered Investment Advisors are compensated perpetually based on assets under management in variable return markets -- most do not yet accept annuities as part of their ongoing prudent process (especially the immediate-fixed category).

Thorough: Researching creditworthiness is critical, complicated to do thoroughly, and is just the beginning. There are also subtle tradeoffs between the various product features to consider. What is guaranteed by contract versus subject to change in the future – either at the discretion of the insurer, the random returns of the markets, or both?

Analytical: Who owns inflation risks - the issuer, or the consumer? Are the costs easy to find or are they embedded in spreads and participation rates? Where are the implicit costs inside the contracts in addition to the explicit ones?

Supplying educational resources will require an objective point of view, including about where annuities fit into a participant's total portfolio. It is important to learn how mortality pooling enables a unique promise: it can provide income that is both guaranteed for life *and* higher than the ten-year treasury rate (while mutual funds cannot). Also unique, this guaranty is offered for more than just one life (another fact to know for the lifetime income illustration safe harbor).

Properly educated consumers may choose annuities because they prioritize a desire for life long financial independence ahead of the possibility that good luck in risky markets will allow them to maximize inheritances. For this kind of retiree, selecting an annuity as a hedge for longevity risk may be about managing the fear of becoming a financial burden to family. Their decisions are about tradeoffs and their need is to understand what their options are.

How to begin the first plan sponsor meeting? We recommend against simply starting with quantitative data for costs and performance for three reasons: 1) institutional pricing for many products is already available to plans (and sometimes to individuals directly) so concerns about high retail costs may not apply; 2) starting with individual product comparisons is the equivalent of doing a manager search before creating an asset allocation policy; and 3) existing institutional best practices have long differentiated between past performance and expected future returns -- shouldn't'this standard also be applied to annuities? Computer tools are no solution for the qualitative research needed here.

Instead, we recommend beginning the conversation at the policy level: "Why should we consider it?" "What life stage would we solve for -- accumulation, near-retirement, decumulation -- or perhaps all three? If our participants vary in their willingness and/or ability to digest the complexity of different products, should we allow a default for them inside the plan, or does this create too much for us as fiduciaries? Perhaps a menu of different solutions for various levels of participant sophistication and preferences would be best, some (or all) of which could be executed outside the plan and accompanied by unbiased educational content?"

Next comes the critical issue of counterparty risk. There are substantial differences in the use of offshore reinsurance -- and the potential risks involved. Congress is currently evaluating this, making it important for plan sponsors to be aware of. Analysis of past insurer insolvency events and the history of allocated versus unallocated contracts is relevant, as is research on state guaranty association differences and past precedents for receivership situations. This will all require expertise.

Should a prudent expert apply existing standards for diversification? Participants could allocate across multiple carriers to lower their counterparty and guaranty association risks. We think the institutionally priced fixed immediate annuity platforms with multiple issuers will help make this a best practice.

Liquidity in the income phase – or perhaps lack thereof – is important to understand. How do withdrawal rights of different immediate annuities (SPIAs) compare based on differences between issuers? How might plan sponsors evaluate this relative to income riders? A "cash refund" or "period certain" option offered by many (but not all) companies may allow for SPIA withdrawals that are like the liquidity features of income riders after they are activated. There

is an added cost for this option that should be part of a comparison of the different types of annuity income categories. Educators need to explain that in both cases liquidity declines over time and may cause a reduction in income guarantees.

Inflation is another part of longevity risk, and different kinds of income “ratchets” are available. Options may be guaranteed or variable - usually differ by annuity type. Graduated ratchets are available in many fixed immediate products, from one percent to six percent annually. This lowers the initial income, but academic research shows participants will often choose them when properly educated about maintaining purchasing power over a long retirement. Other COLAs may be tied to capital markets, offering potentially higher future purchasing power but also the risk of potentially less purchasing power over time versus the guaranteed ratchet.

Should the income available to participants who wish to annuitize before a rider deferral period ends be evaluated versus an immediate annuity? What about the cost of dividend loss in some products? Sponsors may want to consider a target date fund structure for accumulation that leads to a lifetime income guaranty. They may also want to evaluate an unbundled structure that leaves the current target date fund in place and has the lifetime income piece available only at retirement. Last but not least, costs need to be prudently benchmarked.

This article is not intended to be comprehensive, and even though each of these qualitative issues are complex our conclusion is simple: institutional quality annuity due diligence is important for plan sponsors to begin, and it is likely outside expertise for plan fiduciaries will be needed.

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