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The Fallacy of Institutional Pricing of Annuities

By Tamiko Toland

This article proposes that institutional pricing, though often cited as a benefit of in-plan annuities, is not a salient benefit of them. Institutional and retail annuities differ in design characteristics that render the pricing less important than it is in the case of investments.

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What is one of the most commonly touted benefits of offering annuities within retirement plans? Institutional pricing. I appreciate the impulse to bring it up—after all, cost is a core part of the discussion when it comes to investments available in-plan and it is an important consideration for annuities. However, institutional pricing does not confer the same advantages in annuities as it does in other investments, such as mutual funds, even though both may offer reduced marketing costs and lower or no commissions. Instead, it ends up being a distraction from the benefits of income solutions that speak more deeply to plan sponsors and participants alike.

Pricing in the Investment Framework

Investments available in and out of plan are essentially the same, so scale can render understandable investment management cost savings. Scale does not reduce the fundamental risk that the insurer covers with an annuity. Furthermore, institutional and retail annuities generally have very different designs, in some cases dramatically.

Am I saying that price does not matter and that in-plan annuity should not reflect the institutional nature of retirement plans? Not at all, and it is reasonable for plan sponsors to intuitively expect lower cost for annuities distributed outside retail channels based on their experience with investment options. First and foremost, annuities may or may not have fees in the first place, but I leave this discussion to a follow-up piece. However, additional pricing factors can overshadow the effect of institutional pricing for defined contribution plans. Furthermore, investments, which have cast the mold for our understanding of cost of in-plan offerings, are a poor model to use to understand pricing in annuities.

Pricing in Annuities

Because annuities are a type of insurance, the exercise of pricing is very different from what it is for investment products. For one thing, annuity pricing always involves actuaries whose job it is to figure out the kind of risk the insurer is taking on. For any guarantee of lifetime income, actuaries take into account how long a person might live and how underlying investments that back the guarantee are likely to perform. People who buy retail annuities tend to expect to live longer than the average, so insurers factor this in as well. When the guarantee is one that the policyholder can choose to take (or not) in the future, the actuaries also consider how often they expect people to start taking income—and when. Below, I offer a few related examples of differences in institutional and retail annuity pricing that are unique to annuities over investments.

Unisex vs. Sex-Distinct Pricing

Consider the simplest annuity, the single premium immediate annuity (SPIA). In exchange for a lump sum of money, the insurance company provides guaranteed income for life based on the demographic characteristics of the individual. However, Employee Retirement Income Security Act (ERISA) plans are required to offer a unisex rate, unlike retail annuities (and other plans), which allow sex-distinct pricing. (Although Massachusetts remains the only state that also requires unisex pricing on retail annuities, sex-distinct rates are effectively available in all states. Massachusetts is a member of the Interstate Compact, which does not share this requirement, and the state allows sex-distinct rates filed through the Compact. Montana dropped its unisex pricing mandate on January 1, 2022. ["An act declaring the use of actuarial tables based on sex or marital status to be a nondiscriminatory approach to setting insurance premium rates, except as prohibited by federal law; amending Section 49-2-309, MCA; and providing an applicability date," *https://leg.mt.gov/bills/2021/billpdf/HB0379.pdf*, accessed 2/2/2022]

Unisex annuity pricing famously disadvantages men over women, as men have a shorter average lifespan, so they lose the higher income they would receive when sex-distinct pricing is available. There are obvious problems with a marketplace that encourages certain participants to go elsewhere for higher rates. More pointedly, the retirement plan is not a marketplace and sponsors often select only one issuer for their plans, as is often the case for a target date series or particular investment style. However, the consequences when it comes to SPIAs are entirely different from what they are for investments.

Pricing Effect of a Competitive Marketplace

Analysis of historical retail annuity quotes from Cannex showed that there is no consistency in pricing from any insurer [Blanchett, David et al., "How Competitive Are Income Annuity Providers Over Time?" (July 2021) *https://www.cannex.com/wp-content/uploads/2021/07/Cannex-Annuity-Price-Competitiveness-Brief-2021-07.pdf*]. Not only does the company offering the highest rate fluctuate regularly but it does so without any apparent relationship to factors such as company credit rating or prior rates. A consumer who wants the highest income from a SPIA purchase needs to review quotes from a large number of insurers with acceptable creditworthiness.

A one-year examination of institutionally priced annuities demonstrated similar pricing variability [Hueler, Kelli, et al., "Public Policy and Consumer Disclosure for the Income Annuity Market," *The John Marshall Law Review*, Vol. 46, Issue 3 p. 795-842 *https://paulahogan.com/wp-content/uploads/2020/01/Public-Policy-and-Consumer-Disclosure-for-the-Income-Annuity-Market.pdf*]. This means that, even if one insurer offered a higher payout for an institutional SPIA than its retail SPIA, it is very possible that another insurer altogether offers a higher payout rate in the retail market. Although there is no analogous pricing exercise for mutual funds, most people do not integrate the role of pricing competition into their thinking about institutional annuity pricing. The assumed correlation between institutional pricing and better value for the participant does not hold when the pricing dynamics are so fundamentally different.

Expectations on Usage

The example above details SPIAs, which are available at retirement in some plans. However, we see the most interest right now in solutions that incorporate annuities to build future income potential before retirement. In particular, the aim is to implement these solutions within the qualified default investment alternative (QDIA) and allow participants to accumulate future income for retirement.

Not to put too fine a point on it, but these solutions span the gamut of annuity design and it is fair to say that there is no retail analogue for most of them. That said, many rely on a so-called income benefit—systematic withdrawals that will continue at a guaranteed rate even if the account balance reaches $0. Naturally, some participants ultimately will use that benefit for income and others will not. The assumption around the ratio of who will decide either way is a component of pricing for all annuities with living benefits—retail or institutional.

I have no special knowledge of the expected difference in behavior of plan participants and retail annuity buyers. However, I do know that this is an important component of pricing and that there are differences among distinct cohorts. This may affect pricing of income benefits today or in the future, as insurers adjust pricing of all benefits as factors change and they closely monitor usage of these features.

Is the sole point to derive the highest payout for the participant? According to the Department of Labor (DOL), no, either with the simple SPIA or other solutions that incorporate annuities. Nevertheless, the focus on institutional pricing creates a false parity between annuities available inside and outside of a plan, since one cannot draw a straight line from institutional pricing to a superior rate for the participant relative to a retail analogue that may or may not exist.

Institutional annuities may have institutional pricing, yet this does not mean that the participant receives the highest income possible, even for an income benefit. All things being equal, within the retail marketplace, they might find a better rate or a product design that is more tailored to their unique needs.

A Plan Is Not a Marketplace

The employer-sponsored retirement plan is not a retail marketplace and it is unfair to view its value to the participant through that lens. Outside of the plan, most participants will not have a relationship with a financial professional and may never learn about the value of increasing retirement security through lifetime income, much less get guidance on suitable approaches. After all, the process of selecting and buying an annuity is nothing like buying an exchange-traded fund (ETF) or mutual fund, in part because it can become a lifetime companion and the backbone to a retirement income plan. For those operating outside the realm of professional advice, low-cost do-it-yourself annuity purchasing constitutes a narrow sliver of the consuming public.

The availability of solutions that include lifetime income guarantees within the framework of an employer-sponsored plan is hugely valuable to many workers who may otherwise remain ignorant of the option of an annuity. In turn, this affects their confidence in retiring and may unnaturally delay their ideal retirement date. Employers understand the challenges that this presents. And on the flip side, a well-designed plan appeals to prospective employees who increasingly seek out more than just a paycheck from their workplace.

Old Habits Die Hard

Why, then, do we hear so much about institutional pricing? In large part, it is an inheritance from investments, where an intense focus on fees is rational and the product differences in and out of the plan do not themselves create pricing discrepancies. Add to this a long history of resistance to in-plan annuities; it is no wonder that income solution providers want to use every arrow in their quivers to convince the skeptical that it makes sense to offer participants true retirement security.

While it remains true that annuities offered within an institutional setting should use appropriate institutional pricing, it is crucial to emphasize that this is not the primary reason that employers should consider annuities within their plans, so it should not be the first item on the list.

I propose that the mantra of institutional pricing needs to fade away from the narrative of the benefits of in-plan income solutions for plan sponsors and participants. Instead, it is more important for industry stakeholders who are new to this conversation to understand exactly how valuable lifetime income is to plan sponsors and participants. ■