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A Sticky Widget: Aligning ERISA Fiduciary Standards with Annuity Pricing

By Tamiko Toland and Bonnie Treichel

Tamiko Toland is a former trade journalist who is now a subject matter expert on annuities and retirement income. She co-authored this piece while serving as Director of Retirement Markets for Toronto-based Cannex Financial Exchanges. She is also a Certified Financial Education Instructor.

Bonnie Treichel, JD is the Founder and Chief Solutions Officer of Endeavor Retirement. With expertise as both an ERISA attorney and financial advisor, she created Endeavor Retirement and its signature Navigator platform to provide financial advisors and their plan sponsor clients with a framework of knowledge and tools to simplify plan governance, save time, and better manage fiduciary risk.

This article discusses the fundamental challenges of comparing lifetime income solutions that use different annuities and the value of considering performance-based results rather than relying on fee analysis.

The Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) creates a safe harbor for the selection of a lifetime income provider (insurer) and sets out conditions that must be met by the insurer. The statute further makes clear that there is "no requirement to select the lowest cost contact." [29 U.S. Code § 1104(e)(3)] Even so, cost remains a consideration in selecting a specific in-plan solution, aligning with expectations around investment duties under the Employee Retirement Income Security Act (ERISA) and persistent plan sponsor concerns related to fees when selecting investments. Simultaneously, this superficially straightforward guidance is blind to the issue that annuity fees are not analogous to investment fees, rendering cost-based comparison of annuities challenging.

Lacking a Prescription, Fiduciaries Still Need Clarity

The lack of specificity in the rules is appropriate as ERISA and subsequent regulations are not prescriptive. That said, any advisor or plan sponsor will need education on annuity costs relative to benefits and features to reasonably evaluate annuities.

ERISA has the benefit that its non-prescriptive nature allows plan fiduciaries great leeway to do what is best for the plan and its participants. On the flip side, that nature creates fear for plan fiduciaries who are seeking a roadmap. Unfortunately, the roadmap often arrives in the form of caselaw or after a series of large settlements, both of which are anathema to plan sponsors, who want to keep their names out of the headlines. Therefore, absent this guidance, a plan sponsor may be inclined to operate from a place of fear when seeking to implement new solutions, including annuities, for its plan.

SECURE Act Safe Harbor—and Fog

Major trends underscore the need to expand access to lifetime income in retirement to all Americans, particularly increased longevity in the face of waning availability of defined benefit plans. Congress recognized this need as well as plan sponsors' natural fear about offering lifetime income solutions in the face of ERISA's non-prescriptive nature and increasingly litigious environment when it passed the SECURE Act. To help overcome plan sponsor's reticence in offering lifetime income solutions that might ensure Americans do not outlive their savings, the SECURE Act outlines a safe harbor that protects fiduciaries from liability for their selection of a lifetime income product so long as they take certain steps.

The view that the safe harbor is transformational because it mollifies concerns about annuity selection is welcome but is an oversimplification that skirts important facts. Section 204 of the SECURE Act extends to "selection of an ***insurer*** for a guaranteed retirement income contract" (emphasis added). In the case of the insurer and even some general provisions surrounding the contract itself, the dictates of the safe harbor are quite clear. Specifically, the safe harbor states that fiduciaries who select an insurer for a guaranteed retirement income contract must engage in an objective, thorough, and analytical search [Section 204 of Secure Act]. In addition, the safe harbor is satisfied only if the fiduciary:

(i) considers the financial capability of such insurer to satisfy its obligations under the guaranteed retirement income contract; and
(ii) considers the cost (including fees and commissions) of the guaranteed retirement income contract offered by the insurer in relation to the benefits and product features of the contract and administrative services to be provided under such contract; and

(C) on the basis of such consideration, concludes that—

(i) at the time of the selection, the insurer is financially capable of satisfying its obligations under the guaranteed retirement income contract; and
(ii) the relative cost of the selected guaranteed retirement income contract [] is reasonable.

The multi-part determination of the adequacy of the insurer's ability to pay within the safe harbor is beyond the scope of this article. So long as those representations are met, then the insurer is deemed as being capable of paying.

The tougher inquiry—the sticky widget—is the latter question of whether the cost relative to benefits and product features is reasonable. The regulation goes on to elucidate: "Nothing in this subsection shall be construed to require a fiduciary to select the lowest cost contract. A fiduciary may consider the value of a contract, including features and benefits of the contract and attributes of the insurer (including, without limitation, the insurer's financial strength) in conjunction with the cost of the contract."

The Sticky Widget

An understanding of the legal requirements delivers us to the heart of the challenge: cost-based comparisons of annuities. The difficulty here lies in the fact that there are different annuity structures with different fee structures. On top of this, the annuity can uniquely be "annuitized" and provide a guaranteed stream of lifetime income. However, annuities are also able to offer guaranteed lifetime income through a guarantee attached to the annuity that may or may not have an explicit fee. The annuities available within defined contribution plans may guarantee minimum future income (or not, with the guarantee triggered at retirement) and they may have a variable component before or after income payments begin. Below, we address each of these three factors.

Implicit and Explicit Fees

All annuities may charge fees, but some charge none at all. This is because, while annuity pricing always incorporates operating costs and profit margins, not all annuities charge explicit fees. For example, the simplest kind of annuity, the fixed deferred annuity, promises a declared rate of return in exchange for the money from the purchase of the contract. The insurer bases that declared rate of return on the expected return from the assets the insurer holds minus all of the costs (operational, marketing, capital) and profit margin. Therefore, the total costs manifest in the declared interest rate and not in a fee. The same principle applies to all fixed annuities, even when there are fees for additional features.

By contrast, variable annuities look more like investments with explicit fees that include charges for any additional benefits. Variable annuities are structurally different from fixed annuities and offer a different array of features within a plan, though both can provide guaranteed lifetime income. These variations in pricing structures demonstrate that fees alone are insufficient as a basis to compare different annuities. However, the commonalities between these solutions allow performance comparisons despite profound differences in annuity design and fee structure.

Lifetime Income: Annuitization or the Guaranteed Lifetime Income Benefit

Annuities are named for their ability to annuitize, or provide guaranteed lifetime income, either immediately or down the road, in exchange for a lump sum of money. This feature is part and parcel of any annuity contract. Nevertheless, annuitization among retail annuities is not common, possibly because of the hesitance of many people to commit a large sum to an irrevocable transaction.

As an alternative, insurers can provide a separate benefit that guarantees future income, the most common of which is the guaranteed lifetime withdrawal benefit (GLWB). A GLWB does not require a commitment of a lump sum and gives the client access to the account value, with the caveat that withdrawing over the allowed amount erodes the guarantee. The guarantee allows regular withdrawals from the annuity and assures that payments will continue at a set rate even after withdrawals deplete the contract value. As a lifetime income guarantee, the GLWB is effectively the same as annuitization, although there are plenty of other differences.

The GLWB is appealing for defined contribution plans because it provides full liquidity both while saving and through retirement, as participants may change their minds at any time, even after starting income payments (in this case, excess withdrawals reduce or eliminate the guarantee).

Similar to annuitization, the GLWB is available on all kinds of annuities, including defined contribution offerings. Many people have long associated the GLWB with variable annuities, but we also see them incorporated into in-plan designs using both fixed indexed annuities (FIAs) and fixed annuities.

Each of these designs offers a different set of features and limitations. Fiduciaries will need to evaluate the trade-offs of the features and limitations of each. Fiduciaries should also be aware that all GLWBs establish a base level of income guarantee at the time

A Boundary in the SECURE Act

For all the protections of the SECURE Act—sticky widget notwithstanding—all components beyond the insurer remain outside the scope of the safe harbor. What exactly is included with a guaranteed retirement income contract beyond the insurer? The management, administration, and support of lifetime income solutions can involve complex interactions among different parties that result in a single packaged solution. As crucial as this may be to create a simplified ecosystem and experience for the plan sponsor and participants, the safe harbor does not extend to parties outside the insurer. Thus, the traditional requirements of a prudent fiduciary to prudently select and monitor service providers and investments remains. Separate from the sticky widget that is the focus of this discussion, plan fiduciaries should be mindful of this consideration when evaluating lifetime income solutions. This is no different from the prudent selection and monitoring of a managed account provider, for example, or a recordkeeper or a third-party administrator for the day-to-day operations of the plan.

of the contribution. On the other hand, that guarantee may increase incrementally or it may not do so until retirement. There is no superior format or design, but they all influence performance of the solution.

Guaranteed or Potential Income

Guaranteed future income on a statement has an obvious appeal to participants as they work and save. However, this certainty comes at a price because the insurer must take into account any specific or minimum income it guarantees for the future. Therefore, annuities that offer a less robust *future guarantee* can also provide more latitude in *future potential*. The tension between certainty and potential lies at the heart of lifetime income solutions and plays a role in the performance of those solutions.

Yet again, neither is superior; they are merely different. It is not critical for a fiduciary to understand the actuarial details of this dynamic or deconstruct the factors that drive annuity pricing. Instead, fiduciaries should seek to understand how the products would benefit participants differently so they can consider the potential value to the participants.

How to Compare Disparate Lifetime Income Solutions

The million-dollar question is how to fairly assess lifetime income solutions with very different pricing and design. Quantitatively, there are four key components: guaranteed income; potential future income; lapse value (contract value at any given time); and death benefit.

There are many ways of arriving at these figures—including both methods and factors—that are outside the scope of this discussion. Suffice it to say that any good comparative analysis relies on the use of consistent factors, such as capital market assumptions, lapse rates, and contribution rates, to name a few. Comparisons can examine averages and other statistical results, particularly high and low percentiles.

As a thought experiment, let us compare theoretical Solution A and Solution B. Both rely on a target date design but guarantee future income differently. Solution A uses a variable annuity with a GLWB (with an explicit fee) wrapping the portfolio. Solution B embeds a fixed annuity with a GLWB (with no explicit fee) as part of the fixed income allocation.

It does not take sophisticated analysis to intuit that fees in each case are blatantly different, with Solution A charging much more than Solution B over time. However, an evaluation of performance differences—net of fees—may elucidate important considerations for the plan fiduciary. Again, this is a theoretical analysis of a pair of theoretical solutions.

In our thought experiment, we add up the averages of potential future income, lapse value, and death benefit to arrive at a total economic benefit, and we discover that Solutions A and B are effectively equivalent. This finding is not surprising because every design involves trade-offs that may end up neutralizing each other. The fiduciary must look at the specific results to understand the distinctions in the solutions. It turns out that Solution A offers higher death benefit and lapse values, on average, than Solution B. However, Solution B offers higher average income than Solution A.

Which is superior, Solution A or Solution B? The analysis does not arrive at a conclusion but it informs a fiduciary about performance expectations that guide the determination of fit for a given plan. For example, a plan fiduciary may determine that participants in the plan benefit by entering into retirement with greater income security and gravitate towards Solution B. Another plan fiduciary, considering a population with high turnover and cashout rates might place greater value on the higher lapse values and prefer Solution A. Neither fiduciary is incorrect so long as the fiduciary engages in a prudent process and makes its decision solely based on which product the fiduciary determines is in the best interests of the fiduciary's participants and beneficiaries.

Bear in mind that qualitative factors are also important and may outweigh quantitative ones, especially if those differences are modest. That said, a performance-based comparison can be an invaluable component of the evaluation process when available.

A Sticky Wicket, Unstuck?

As the lifetime income solution market within defined contribution plans evolves, there will be more tools and support available to fiduciaries. The inclusion of quantitative comparisons as part of the evaluation process strengthens the case for placement of a given solution. Nevertheless, even in the absence of such analytics, a basic understanding of the differences in annuity designs and a focus on the expected benefit to participants can go a long way to unsticking the sticky widget. ■