America Speaks Out—and Against—401(k) Annuities

By Editor Test *Wed, Mar 3, 2010*

As of March 2, the responses to the Obama administration's request for input on lifetime options in 401(k) plans tended to be angry but well-reasoned.

"Keep your hands off our 401(k)s!"

That's how Americans are responding so far to the RIF (request for information) about lifetime income options for 401(k) plans that the Departments of Treasury and Labor published in the Federal Register at the beginning of February.

But by March 1, only 48 comments were posted at www.regulations.gov (Docket ID IRS-2010-0006) so it's hard to say to what extent the responses were representative.

So far, no insurance companies or mutual fund providers had submitted their views. Companies that already offer in-plan annuities—MetLife, Prudential, and Genworth Financial, for instance—would be logical contributors.

Not all the comments were written in anger. Many were polite and well reasoned. Two or three even came from professionals, such as a plan sponsor and a financial advisor. But most of them seemed to reflect the latest strain of Tea Party populism.

Judging only by the first four dozen comments, many Americans apparently suspect that the Obama administration plans to confiscate 401(k) assets and somehow use the money to pay its bills, offering nothing but an unfunded promise of lifetime income in return.

No shortage of anger

Two of the earliest comments to the RIF reflected the frustration and anger that so many Americans seem to feel these days:

"If this passes I will halt all contributions and close [my 401(k)] account with penalty. If I wanted Government bonds I'd buy them. You can thank Ben Bernanke and Tim Geithner for people not wanting the bonds.

"There's a reason that the yield curve is steep and the short-term bonds keep going into negative yields, people don't believe the government can fulfill its long term obligations. Cut the spending, cut the deficit and keep your hands out of our 401(k)!"

Here's another in a similar vein:

"No, I'm not interested or willing to participate in any plan that would give the government control of my IRA, 401k, etc. in order to help offset the current administration's deficit spending.

"I didn't contribute funds to my retirement just to have them zapped away by the current group of profligate politicians and others on a wild spending spree, leaving me nothing for my old age… I just don't see how anyone could support it."

Balances not big enough

Not all of the contributors were so incensed. A more deliberate contributor pointed out that most people can't afford a decent annuity:

"It's disappointing to see the DoL get involved in a vendor-driven product. The last vendor-driven initiative taken up by the DoL—the target date fund—had disastrous results in rewarding millions in fees to [a] very small group of mutual fund advisors.

"The annuity initiative seems to be a way for insurance companies to take their turn at the fee trough. The DoL seems to be buying the spin fed to them by the insurance companies that participants are somehow not given the option to purchase an annuity.

"The data is clear: people do not want annuities. People have three good reasons to avoid annuities:

1. 401(k) balances averaging $30,000 provide small annuities (around $2,000 yr) not worth the trouble.

2. All annuities force single entity credit risk (think AIG).

3. Excessive hidden fees. The big gorilla in the room is too small of balances. Let's say to provide a typical DB pension of $30,000 a year you need a 401(k) balance of nearly $400,000. With an average balance in the $30,000 range and the vast majority under $100,000 even the best-constructed annuities would fall way short.

"With high unemployment causing leakage in loans and cashing out, 401(k) balances are growing very slowly. Almost all current annuities force participants to take single entity credit risk.

"If DOL pushes this option does this imply a government guarantee making all annuity providers? Too Big to Fail? Currently there is significant credit risk in all annuity providers as indicated by bond spreads. Annuities are currently regulated by State Insurance Commissioners. Providers flock to states with the most lax regulation.

"DOL should think long and hard before pushing participants into risky products that the government may have to bail out later."

'First, do no harm'

But others brought a more informed perspective to the discussion. James Hardy of Tacit Knowledge, a San Francisco software company, warned about the dangers of mandatory annuitization:

"As the plan sponsor/trustee for a 401(k) plan, I think having some form of annuitization available to plan participants would be nice and would make sense for some, some of the time (as with any investment choice).

"However, and I want to make this very clear—any annuitization option should not be mandatory, and it must not be conflated with safe harbor rules on default enrollment such that people are unknowingly forced into irreversible investment options when they are potentially not paying attention.

"Making any annuitization option mandatory or making it the only safe harbor choice for default enrollment of new hires would remove choice, possibly cause loss/hardship if the funds were needed and thus potentially violate the 'first, do no harm' ethos a plan sponsor choosing default options should have."

Teach financial literacy

A financial advisor who described himself only as "David" pointed out that America needs more self-reliance, supported by financial education:

"I have been in the business of advising individuals and business owners about retirement planning for 24 years… Defined contribution plan participants already have plenty of lifetime income options available, and the burden of federal regulation on plan sponsors is a significant disincentive to employers to offer a retirement plan for their employees.

"The need that is not being adequately addressed is the need to accept responsibility for one's own financial security, rather than depending on an employer, the governme nt or the public. People need more education, beginning in elementary school, of the need to spend less and save more, and how to invest wisely for the long term… Let's put our energy and resources into educating the public."

A lack of inflation-protection

A contributor identified as "DM" also tried to be constructive:

"Annuities are an excellent option. They provide lifetime income and allow individuals to determine how much they need to save to achieve a desired monthly income. States also provide protection, within limits, for this type of insurance. Consequently, this may require the use of multiple insurance companies to achieve an individual's goal and, at the same time, protect the money invested in the policy.

"The downside is the lack of reasonably-priced inflation protection. Although available, it is too expensive to be practical. If more individuals were involved in the purchasing pool and the price came down, this would make a lifetime annuity even more attractive. Once the monthly income goal is achieved, it would provide piece of mind and limit the temptation to choose a risky alternative."

Reduce taxes

Peter Bowler, writing from Akron, Ohio, suggested that an exemption from taxes would make annuities more attractive:

"Although I could support the idea of adding annuity choices to 401(k) plans, it is not any sort of final solution to the retirement income problem. What would be more helpful would be a reduction in taxes owed on distributions of all kinds that would preserve more of the capital so hard won over the years."

Stop the export of U.S. jobs

David Young, no address given, answered four of the 39 questions posed by the Labor and Treasury Departments, then offered some direct observations related to the macroeconomic outlook:

"Question 1: Payments must be indexed to inflation (i.e., maintain constant purchasing power over time).

"Question 2: My strongest concerns are conversion cost (i.e., converting to an annuity in a low interest rate environment), plan fees and counterparty risk. Are there steps that [federal] agencies could or should take to overcome at least some of the concerns that keep plan participants from requesting or electing lifetime income? Other than leaning on the Fed to stop holding interest rates artificially low, I can't think of anything.

"Question 8: Plan sponsors can vet potential annuity providers before offering their products to employees. This may give employees greater confidence in a particular annuity seller and their products.

"Question 13: Should some form of lifetime income distribution option be required for defined contribution plans (in addition to money purchase pension plans)?

"Yes; however, whatever action is taken with respect to offering a lifetime income option, it must remain just that-an option. There should be no conversion requirement imposed on defined contribution plan participants.

"If so, should that option be the default distribution option, and should it apply to the entire account balance? No, it should not be the default option and it should not apply to the entire balance.

"To what extent would such a requirement encourage or discourage plan sponsorship? I think offering the option, and associated plan communications about this option to employees, would be sufficient.

"General Comments:

> 1) The retirement security of all workers would be enhanced if government policy did not facilitate the export of U.S. jobs. A start would be to address the mercantilist polices of our East Asia trading partners.
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> 2) 'Good jobs provide wages that support families, and rise with time and productivity.' Odd; productivity has risen over past 10 to 20 years with no appreciable increase in inflation-adjusted wages. Perhaps DoL and Treasury should examine why this has occurred.
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> 3) The Department of the Treasury could promote economic growth, stability, and economic security by stopping the direct and indirect bailouts of insolvent financial institutions.