One Man's Response to Uncle Sam's RFI

By Editor Test *Tue, Apr 13, 2010*

Joe Bellersen, president of Qualified Annuity Services, Inc., explains how employer plans lost their guaranteed income mojo over the past 30 years, and offers advice on how they might get it back.

As president of Cincinnati-based Qualified Annuity Services Inc., Joe Bellersen has helped many firms convert their defined benefit plans to group income annuities. Until recently, he also distributed Ca nada Life income annuities in the U.S.

So when the Departments of Labor and Treasury solicited public input on lifetime income solutions for 401(k) participants back in early February, Bellersen needed little prep work in order to write up his answers.

Joe knows annuities. Many responses to the DoL's RFI have come from angry citizens, most of them warning Uncle Sam to keep his confiscatory hands off their savings. But Bellersen's 65-page document, with charts and appendices, was informative and enlightening. (Other formal and ambitious comments have since been submitted.)

In it, he offers his explanation for how employer-based retirement plans and individual annuity products came to lose their original lifetime income focus. And he offers suggestions on how we may be able to restore that focus.

As he sees it, the inflation-breaking high interest rates in the early 1980s and the subsequent equities boom helped stimulate the rise in lump-sum payouts from defined benefit plans. And a 1994 Supreme Court decision helped recast variable annuities as accumulation tools and eclipse their annuitization feature.

Now, with the mid-decade boom over and the Boomers slouching toward retirement, Bellersen urges a return to that lost focus on guaranteed lifetime income, particularly the kind that's funded by life insurance company general accounts and based on mortality pooling.

Of course, he's biased. That's what his business is based on. On the other hand, he doesn't pretend that putting the annuitization genie into 401(k) plans—or back into DB plans—will be easy. "Joe has some strong opinions," said Lowell Aronoff, CEO of Cannex Financial Exchanges Ltd., which provides income annuity data to Bellersen's company. "But he's very knowledgeable."

How we got to where we are

Bellersen points to a contradiction that's lying in plain sight but that hardly anyone ever mentions. Even as we discuss annuities for defined contribution plan participants, most people with defined benefit plan coverage don't take annuities when they separate or retire. If they have a lump sum option, they usually take it.

[As Vanguard retirement researchers Gary Mottola and Stephen Utkus pointed out in a 2007 paper, "Lump Sum or Annuity? An Analysis of Choice in DB Pension Payouts," only 27% of lump sum eligible employees in a traditional defined benefit plan took lifetime income at retirement or separation and only 17% of people in a cash balance DB plan did so. Less than 20% of those ages 55 to 60 took an annuity.)

The spike in interest rates in the 1980s, and the long bull market that followed, helped foster the trend toward lump sum payouts from DB plans, Bellersen says. High interest rates reduced the present value of annuities, so that sponsors could save money by paying lump sums. For participants, the rising stock market made lump sums look like a better bet.

"The broader use of LSDs [lump sum distributions] was due to the very high interest rates available for discounting distributions on plan terminations," he told RIJ. "It gathered steam as plans realized that offering a lump sum as an 'optional form of an annuity' allowed the liability to be removed from the sponsor's balance sheet at a discount.

"The participant will grab the lump sum regardless of whether it's the right thing to do. You can talk to them till you're blue and they wont choose a pension. They'll choose instant gratification. There's a complete disconnect," Bellersen added.

He finds it ironic that the government wants 401(k) participants to do what DB plan participants have stopped doing. In his comments to the Labor Department, he writes, "We must pause to ask these questions: 1) Why have DB plans been permitted to become cash bonus plans? 2) If DB plans are cash bonus plans, then why expend efforts on making DC plans income replacement plans?

"There seems to be inherent contradiction with regard to the retirement income policy. This is a paradox." If we're going to talk about lifetime income for 401(k) plans, he says, we should also think about restoring lifetime income to DB plans.

Fateful Supreme Court decision

Bellersen points to another inflection point in the saga of the decline of lifetime income over the past 30 years. A single court decision, he said, catalyzed the metamorphosis of variable annuities into tax-deferred investments from retirement income tools.

"In 1994 the Supreme Court held in NationsBank of North Carolina, N.A. et al. v. Variable Annuity Life Insurance Co. et al., that the Comptroller of the Currency was allowed to conduct annuity transactions. The Supreme Court granted rights for banks to sell annuities on the premise that conducting such sales were 'incidental' to 'the business of banking.'"

In the process, variable annuities turned into tax-deferred mutual fund portfolios. "The court went on to cite: 'The Court further defers to the Comptroller's determination that annuities are properly classified as investments, not 'insurance' within §92's meaning.' This decision cleared the hurdles and was a watershed event allowing the sale of annuities by banks and imposing a product-driven mentality."

If that's true, it's easy to see how the Supreme Court decision may have unintentionally enabled the subsequent spate of alleged "unsuitable" variable annuity sales. "This decision eliminated the theory of insurance since it focused solely on the tax deferral aspects of annuity contracts and was supported by professional opinions that 'no one ever annuitizes.' Such a bold categorical declaration permitted deferred annuities to be sold on the basis that 'one size fits all.' Nothing could be further from the truth," Bellersen wrote.

Yet another smoking gun in the demise of defined benefit plans was the 50% reversion tax on pension surpluses that was enacted in the early 1990s. As many have pointed, this tax led to underfunding and plan terminations. In response, the sponsors decided that "rather than add contributions and invest in the same way as before, we'll put in less and take more risk," he told RIJ.

Recommendations

Introducing a guaranteed lifetime income to employer-sponsored plans will require several reforms, Bellersen concluded. Among them would be the provision of participant education to help people understand the full value of guaranteed lifetime income and the reason why annuities cost more than investments, the resolution of gender differences in payout rates, and the tailoring of income solutions to individuals, so that people with ample defined benefit income, for instance, don't necessarily annuitize their defined contribution savings.