Phyllis Borzi, Savior of Tax Deferral

By Kerry Pechter *Thu, Mar 17, 2016*

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Like a rain delay in the middle of a close baseball game, the DOL fiduciary rule's stopover at the Office of Management and Budget gives us all a chance to exhale, grab a hot one and a cold one, and ponder the meaning of what Phyllis Borzi and her legal team are trying to do.

Just for the sake of argument, let's imagine that she's trying, perhaps even without knowing it, to save the tax-deferred retirement savings system from itself. That may sound ridiculous, but please hear me out. [According to latest rumors, the new rule will emerge from OMB as early as this week but no later than April 1.]

The apparent aim and effect of the DOL rule is to expand the perimeter of the regulatory fence around 401(k) plans to include retail rollover IRAs. I think the DOL wants the investing experience of IRA rollover owners to look and feel like the experience that IRA rollover owners knew when they were participants—an online, low-cost, education-oriented, no-hard-sell, group experience.

I think the government has concluded that the rollover IRA itself is an unintended consequence of the tax code, and that tax-deferred retirement savings shouldn't have been allowed to slip out of the pension world and into the retail brokerage world in the first place. The fiduciary rule is an attempt to put the toothpaste back in the tube.

And no wonder the brokerage industry hates it. Such a sudden expansion of the ERISA perimeter naturally seems like a radical asset grab. It's as if the government decided to re-nationalize the country's telecom sector. Or as if the Interior Department tried to extend the borders of Yellowstone Park to include Wyoming, and to establish a state-wide ban antelope hunting.

Although the DOL may merely want to ensure that IRA rollover clients enjoy the same protected environment that qualified plan participants enjoy, the effect will be to take pricing control away from private companies who want to sell to products and services to retail IRA owners. Because there's more than $7 trillion (and growing) in rollover IRAs, any form of direct or de facto price suppression is going to hurt broker-dealers.

One less basis point in annual fees on $7 trillion is $700 million in lost revenue. That’s a lot of antelope.

This is what we’re talking about when we talk about the impact of the DOL rule. No abstract legal principle is at stake. It’s not about ethics per se. It’s not about the “definition” of a fiduciary. It’s not about depriving IRA rollover owners of access to advice.

If anything, it’s about depriving the sellers of retail financial products access to rollover IRA owners. It’s about taking bread off their tables, bonuses away from their Christmases, and sources of college tuition away from their gifted children—so that fewer retirees end up broke, on public assistance, or spending their final years at Medicaid-funded nursing homes.

Hybrid robo-advice is hot right now, in part, because hybrid robo is what participants in qualified plans experience. That’s why the robo companies are cheering on the DOL, and vice-versa. That’s why incumbent 401(k) providers like Vanguard and Schwab are also the best-known robos. That’s why Financial Engines, the so-called granddaddy of today’s robos, is well-positioned to benefit from the DOL trends. (Annuities, which have difficulty fitting into much of the 401(k) space, may not fit easily into the DOL’s vision of the rollover IRA space. The rule requires sellers of variable annuities to sign a Best Interest Contract.)

So what makes Phyllis Borzi the savior of tax-deferral? If rollover IRAs are not pulled under the ERISA umbrella, then people will see the 401(k) system for what it threatens to become: An incubator for high-cost, retail rollover IRA accounts. If you allow brokerages to charge IRA owners whatever the market will bear, then tax deferral begins to help brokers as much as or more than it helps retirees.

Taxpayers won’t tolerate that forever. If enough people become convinced that tax deferral helps brokers at the expense of savers, then budget hawks will regard the $100 billion-a-year cost of tax deferral as fair game for elimination.

Don’t get me wrong. I think the DOL could have done a much better job with this initiative. It’s “Just Say No” approach to deceptive sales practices looked like a one-size-fits-all solution to a highly nuanced problem, and it did not seem to demonstrate a clear appreciation for those nuances.

But the sober truth is that tax deferral isn’t free. Intrusions like a no-conflict-of-interest rule for rollover IRAs are part of the price you pay for it. A subsidized market has to be regulated. Hoping for the “gain” of tax deferral without the “pain” of lower fees and higher ethical standards is hoping for too much.