Retirement Income
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Should Participants Get Lifetime Income By 'Default'?

By Kerry Pechter *Wed, Jul 31, 2024*

The ERISA Advisory Council heard testimony on whether to tweak the rules for Qualified Default Investment Alternatives to accommodate—or exclude—annuities. Advisors to 401(k) plans should read this.

If you have a stake in the sale of annuities to 401(k) plan participants, then the testimony offered at the ERISA Advisory Council's (EAC) July 10-12 meetings on "Lifetime Income and Qualified Default Investment Alternatives" (QDIAs) may interest you. I attended by Zoom.

QDIAs, as most *RIJ* readers will know, are the investments that, under pension law, retirement plan providers are allowed to direct the contributions of auto-enrolled participants into. The most popular QDIAs are target date funds (TDFs). TDF assets reportedly account for half of the $7.4 trillion in 401(k) plans.

One promising path to embedding annuities into 401(k)s is to graft income-producing sleeves onto the TDF root stock. Several TDF providers have partnered with annuity issuers to bring "hybrid" TDF-annuities to the 401(k) market.

These asset managers and insurers are betting on a future where participants who have been auto-enrolled into plans, and who auto-contribute to TDFs, will automatically begin funding their deferred annuity sleeves at about age 50. At age 65, they can choose to convert (or not convert) the sleeves into guaranteed income.

Doubts remain

The SECURE Act of 2019 appeared to indemnify plan sponsors from legal liability for choosing an annuity provider that unforeseeably goes bankrupt someday. But the law doesn't make all plan sponsors feel safe from potential lawsuits, like those filed this year against AT&T, GE and Lockheed Martin for selling their pensions to Athene.

While a 2014 letter from the Department of Labor smiled on the grafting of deferred annuities onto existing QDIAs, some legal advisers to plan sponsors want the DOL to tweak its definition of QDIA to give sponsors more legal cover for adopting hybrid investment/income solutions that include annuities.

Hence the testimony on that topic in the July EAC meeting. The meeting was chaired by Jack Towarnicky, former president of the Plan Sponsor Council of America. The 15 members of the EAC come from a range of professional backgrounds, and represent many different perspectives on benefits-related issues.

In 2023, the council heard testimony on IB 95-1, a 30-year-old DOL bulletin that requires plan sponsors to choose the “safest available annuity” when replacing a defined benefit pension with a group annuity issued by a life insurer. The EAC subsequently advised the DOL not to change IB 95-1, and acting Secretary of Labor Julie Su sent that advice on to Congress last June.

Testimony at last month’s EAC meeting showed that many thorny conflicts will need to be resolved before deferred annuities become a common 401(k) investment menu item, let alone part of one of the QDIA investments that plan sponsors can “nudge” their participants into.

Here are selections from the testimony I heard on July 10, 11 and 12:

What employer/plan sponsors are saying privately. “Employers seem to want to improve retirement outcomes for their former employees. They’re not saying, ‘This is not our problem.’ But there are still an overwhelming majority of DC plan sponsors who are not taking action with respect to retirement income solutions. To be an early adopter is to make the plan look like an outlier and draw the attention of plaintiffs’ attorneys. The administrative complexity of annuities is another concern,” testified Gregory Fox, partner and head of Retirement Income Solutions at Aon Investments USA.

“Cost is a third concern. There’s the cost of selecting an annuity and monitoring the performance of the annuity. There’s the cost of formulating a governance process. That’s on top of the fee levels of the products themselves, which may not be transparent. How does a plan sponsor determine if a non-transparent cost is reasonable or not? [Regarding participants] there’s been limited adoption by participants in the plans that have adopted annuities. When the annuity requires an ‘opt-in’ by participants, we haven’t seen many participants take action. If the annuity requires engagement at the point of retirement, the jury is still out on whether we’ll see uptake by retirees.”

The multiple plans problem. “401(k)s are mid-career accumulation vehicles” that don’t naturally lend themselves to retirement income planning, said Brad Campbell, attorney at Faegre Drinker and former head of the DOL’s Employee Benefit Security Administration, or EBSA.

Changes in the QDIA regulation could help plan sponsors pick a drawdown mechanism that would pose the sponsors no legal jeopardy, but it wouldn’t help retired couples turn multiple qualified plan accounts into a suitable retirement income plan. My wife and I might have three plans, and we might be offered three entirely different distribution solutions, none of which makes sense as a cohesive or coherent whole.”

Let competition produce solutions. “There is a population of participants that would benefit from an in-plan income stream. The research bears that out. And the marketplace is developing new products and new middleware and is addressing the shortcomings and downside risk,” said Tom Clark of the Wagner Law Group, which advises plan sponsors on legal risks.
“If any (or all) are too expensive or not transparent enough or not portable enough, [plan sponsors] will push back and the marketplace will adjust and continue to evolve. And there are certainly approaches that can be taken in delegating to a 3(38) investment manager to lower the exposure for plan sponsors. Not eliminate it, but lower it.”

A menu of income-generation options. “Choosing a life insurer is a permanent decision,” Fox said. “Even if a plan sponsor replaces a life insurer, a participant’s benefits will still come from the old company. That’s a cause for concern. That’s why it will be important to diversify the types of distribution solutions. Not everyone will be drawn to a guaranteed solution. One solution won’t be the magic wand. Instead, it might be better to have three or four different income options in the same menu. That’s where we think this trend will go.”

Sponsors need more protection from litigation risk. A better safe harbor “would be look like the IB 95-1 set of criteria,” said Fox. “It would be more prescriptive of the plan sponsor’s process in formalizing its relationship with an annuity provider. That would give plan sponsors more comfort, and provide familiarity. In the absence of specific evaluation criteria—more than a one-pager—the SECURE Act doesn’t feel like really good protection from litigation risk. We need a more prescriptive process.”

‘Portability is big.’ “Plan sponsors don’t want to be the first or last [adopters of annuities],” said Mercer’s Preet Prashar. “They want to be in the middle, when programs have already been debugged and problems have been addressed. Then there’s the infrastructure matter. Portability is big. They don’t want to feel locked in with a certain recordkeeper. That would add another layer of comfort [to adopting annuities].”

Annuities aren’t the only way to generate retirement income. “All lifetime income is retirement income, but not all retirement income is lifetime income. Some solutions aren’t guaranteed,” said Fox. The current focus on annuities, he suggested, risks over-complicating the income distribution challenge. There are lots of simpler solutions, like making it cheaper and easier for retirees to take withdrawals from their plan accounts. "Participants need more withdrawal functionality from recordkeepers.

"If I'm retired and still invested in my plan's TDF, how many different ways will I be able to pull money out? Can I set a fixed periodic withdrawal percentage, a fixed withdrawal amount, a rolling average of my account value, a method that smooths the volatility of my withdrawals? There is an infinite number of ways to produce income without adding a single new investment option. Those solutions have nothing to do with guarantees. There are more elegant ways for DC plan participants to think about their savings in terms of retirement income."

Plan recordkeepers can't absorb the cost of more withdrawal functionality. "A tension that we identified was that recordkeepers are struggling with a low margin business. So the majority—a modest majority—of recordkeepers charge fees for periodic withdrawals. So when we asked if they're ready to cut withdrawal fees, they said no, they're financially constrained from doing so. But they said that if it's part of a long-range change [in plan design], then it may be possible to waive those fees," said Lew Minsky, CEO of the Defined Contribution Institutional Investors Association, which recently surveyed plan recordkeepers regarding 401(k) income solutions.

"We're putting a lot on plan sponsors," Minsky said. "Waiting for them to focus on retirement income isn't productive. And when you're talking about sponsors, especially in terms of desire for retention of assets, it's a tale of two markets: Large and 'jumbo' plans versus smaller plans." The income challenge is complex, he said, and "complexity seems to be associated with inaction. Once you encounter complexity you raise the fear of litigation." As a plan provider, you want to "make yourself as small a target [for litigation] as possible."

The why-go-there perspective. "I don't believe annuities should be included in plans and definitely not in a QDIA. ERISA doesn't require plan sponsors to offer annuities, so why go there?" said James Watkins, an ERISA attorney who advises plan sponsors. Louisville attorney Christopher Tobe, another plan sponsor adviser and Watkins' fellow contributor to **Commonsense401kproject.com**, was equally negative about annuities in 401(k)s. "Fees are already a major drag on balances. You don't need to annuitize your 401k balance. Just say how much you want to take out a month. I'm perplexed why people would want to put an annuity in a QDIA."

Keep the status quo? "When we look at its impact on the accumulation phase, the QDIA has been a success," said Charles B. Wolf, an EAC member and retired Chicago attorney who advised employers on retirement plans. "Now we are all asking whether QDIA should be tweaked to address the retirement income gap. I'm hearing that currently, maybe we shouldn't do anything new and should continue to treat the decumulation phase in the same manner as now."

Can't afford to ignore longevity risk. "If as a society we do nothing to proactively solve for this gap in the average person's ability to spend down their savings and not outlive their savings, then we will have to reactively solve for it," Aon's Fox said. "Whether it's a matter of changing the QDIA regulations or of protecting employers from litigation, the answer is not that we should do nothing right now."