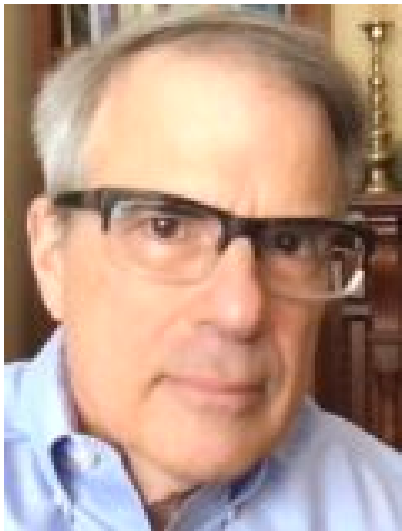

Test Your '401(k) Annuity' Math Skills

By Kerry Pechter Tue, Oct 1, 2024

Should 401(k) participants pay fees on annuity benefits they don't know they have, and never use? Are 'in-plan' annuity fees 'fixed' if the issuer can change the benefit crediting rate? Someone, somewhere, must know.



Actuaries and math puzzle-solvers, here's a question. Several novel target date funds (TDFs) have come to market in which deferred annuities are embedded as one of the investment sleeves. These TDFs are intended to be distributed through 401(k) plans as qualified default investment alternatives (QDIAs) for auto-enrolled participants.

Here's how they work: When participants who are auto-invested in the TDFs reach age 45 or 50, increasing percentages of their contributions begin to spill over into the deferred annuity sleeve. At age ~65 or so, the participant must decide whether or not to convert the amount in the annuity sleeve to guaranteed lifetime income.

Like safe drivers' car insurance?

The conundrum concerns the asset-based fee on the contents of the deferred annuity sleeve during accumulation. Starting at age 50, the participant might pay as much as 100 bps/year on the assets in the sleeve; in return, typically, the annuity issuer sets a floor under the sleeve's accumulation. But the floor (as I understand it) is contingent on the participant's decision at age 65 to convert the sleeve assets to guaranteed income.

If there's no conversion, the floor vanishes and the participant has only the amount in the sleeve. Some people have worried that participants who have paid the annual 100 bps for 15 years but never opt into the annual lifetime income stream (~5% - 6% of an amount no less than the floor) may feel robbed of the fee (which may have eroded their accumulations along the way).

But one witness at a meeting of the ERISA Advisory Council this week suggested that those participants might be like people who buy car insurance but never have accidents: they shouldn't feel robbed of their premium.

So, is the 100 bps drag on the TDF sleeve an unfair charge for participants who don't opt into the annuity at retirement? Or does it have value either way? What if the participant could see that her account balance was higher than the floor, and so declined the income benefit because it wasn't "in the money." Did her 100 bps have insurance value? Was it like an call option that served its purpose and died?

Some actuarial wisdom is needed here, perhaps. Future plaintiffs' attorneys may examine this question carefully. BTW, this is not a new problem. Living benefit riders on individual annuities have posed similar ambiguities. Now the 401(k) world is about to experience it.

Is the fee fixed or variable?

Here's another question for those with high numeracy quotients. Suppose an insurance wrap fee during accumulation is fixed at 100 bps for the participant in the TDF. (Ignore whether the whole TDF or just a sleeve is wrapped, and the age when the billing starts.)

If the wrapper offers a floor, and resets the future minimum benefit every year, will the wrap provider (the annuity issuer) need to change the crediting rate in response to changing interest rates and the participant's rising age? (In a multi-insurer lifetime income benefit auction system, each insurer's appetite for a piece of the business may also affect its crediting rate bid.)

Is changing the crediting rate each year or month tantamount to changing the product fee? I don't know. If it is, fiduciaries may need to justify that uncertainty. What might happen to crediting rates if the next financial crisis brings a new ZIRP?

Clearly, it is difficult to draw general conclusions about in-plan annuities, since features vary so much and the benefit can be variable.

Out-of-plan annuities are usually fixed, simpler, not linked to QDIAs, and provide less (or no) liquidity. They entail fewer fiduciary issues. But they're much harder to get participants to use. I review out-of-plan annuities (and in-plan QLACs) in this and future editions of *Retirement Income Journal*.