The Four-Sided Chess Game

By Kerry Pechter Tue, Oct 22, 2013

Today, insurers are invoking fiduciary duty to justify the offering of lifetime income products in 401(k) plans. If the fiduciary standard were applied to the management of money in rollover IRAs, they might use it to persuade advisers to put part of their clients' savings in annuities.

In the four-sided chess game that is the retirement income industry, the chess piece known as the rollover IRA is either one of your most powerful weapons or one of your worst nemeses.

Last week, I attended a Financial Research Associates conference at the Harvard Club of Boston, which is not far from the jazz-driven Berklee School of Music and only a few steps from the intersection where leafy Commonwealth Ave. crosses congested Massachusetts Ave.

The topic was a timely one: "Capturing Rollovers." Rollover IRAs, of course, represent a large and growing asset pool. As Americans change jobs and retire, millions of them eventually they transfer—"roll over"—their tax-deferred plan accumulations to tax-deferred rollover IRAs. Except for the ability to borrow, IRAs usually allow them much more control and flexibility than employer-sponsored plan accounts do–but also lack some of the most important benefits of employer plans.

The 401(k)-to-IRA trend is a slow-motion tsunami. It has progressed to the point where traditional IRA assets (including rollover IRAs and the under-used "contributory" IRAs) now outweigh 401(k) assets. According to Investment Company Institute data, in 2012 there was more than $5 trillion in IRAs of all types and $4.7 trillion in defined contribution plans. Together, DC plans and IRAs account for more than half of the $18.54 trillion in U.S. retirement savings.

Most of this money comes from out of mutual funds (including target date funds) in employer-sponsored plans and goes into mutual funds in IRAs. As of Q2 2012, $2.3 trillion of IRA money (46%) was in mutual funds, $493 billion (10%) was with banks and thrifts, and only $356 billion (7%) was at life insurers (including mutual funds in insurance products). About $1.94 trillion (38%) was in assorted securities in brokerage or trust accounts.

Unless this tectonic trend magically reverses direction, the implications for the various interested parties in the retirement income industry are huge. This is obviously good for mutual fund companies and financial advisers who engage with wealthier IRA holders. So far, it’s creating a dilemma for two other players at the chess board: life insurers and the Department of Labor. Let’s consider the life insurer view first.

Life insurers have to wonder, where do we focus our annuity sales efforts? As Francois Gadenne of the Retirement Income Industry Association pointed out in his presentation at the FRA conference, where do life insurers take on retirement risk exposure and expend their constrained capital (much of it tied up in their variable annuity books of business) during this extended period of low interest rates?

Life insurers appear to have a couple of options. They can aim low-cost in-plan deferred variable annuities (during employment) or immediate income annuities (upon separation) at participants, reminding plan sponsors that their fiduciary chores include helping participants turn their savings into safe lifelong income. Or they can market higher-cost individual annuities to investment advisers and financial planners, many of whom help clients decide what to do with their rollover IRA assets.

Judging from the flow of money from 401(k) plans to rollover IRAs, pitching annuities to advisers would have more potential and higher profit margins. But that’s easier said than done. Life insurers haven’t yet convince a critical mass of adviser that retiring without an annuity is like driving without a seat belt.

Each life insurer (and others in the retirement supply chain) who wants a piece of the retirement market will probably have to decide which pool of assets (401(k) or IRA) assets to focus on. That will probably depend on whether the life insurer specializes in annuities, or is equally happy selling annuities or mutual funds, or is a major 401(k) provider, or is a unit of a big diversified institution, vying with other business units for attention.

Making fun of the DoL

Aside from fund companies, insurers, and advisers, the fourth (and least popular) player in this four-sided chess game is the government. At the FRA conference, a few panelists made fun of the DoL’s Phyllis Borzi and the Government Accountability Office, whose representative couldn’t show up because of the government shutdown.

With the production of a little skit, in fact, they made fun of the DoL’s alarm over the movement of retirement savings from the ERISA-regulated, fiduciary-standard world of employer plans to the SEC and FINRA-regulated buyer-beware world of rollover IRAs. They do not want to see Borzi extend ERISA and the fiduciary standard to the rollovers. That would dampen the opportunity.

If you believe that Boomers are entitled to do whatever they want with their savings, Borzi's 2010 proposal (currently in rewrite) to put the government's hands into the nation's rollover IRA pocket will seem like a clear case of regulatory overreach. But I think Borzi has a point. If she had her way, it might even be good for annuity insurers.

Just as tuition-paying parents fret when a 18-year-old daughter moves out of their home, where she was (more or less) subject to their rules and supervision, into a co-ed dormitory on a wet campus, I'm sure that Borzi frets about the movement of subsidized retirement money from the fiduciary world of a 401(k) plan to the suitability world an IRA. Like a parent, she'd probably like to see a few family-of-origin rules applied even after the transfer occurs.

It's not just about policing behavior. When retirement money moves to an IRA, it may no longer have the benefit of automatic monthly contributions, contribution limits are lower, fees are potentially much higher and there's no employer match. Consequently there's a danger that nest eggs will not be as large and more (especially middle and lower-income) retirees will eventually run out of money, perhaps needing public assistance. Hence the DoL's concern about the migration of money to rollover IRAs.

Does the government have any business meddling with regulation of IRA money? Arguably it does. Uncle Sam's tax expenditure (tax not collected) for contributions to retirement account contributions (Keogh, defined benefit, DC and traditional IRAs) was more than $150 billion in 2012. This tax expenditure (necessarily coupled with required minimum distributions starting at age 70½) exists to further a specific public policy goal: enhancing retirement income and supplementing Social Security. Regulation (and the fee suppression that goes with it) may be the price of the privilege of tax deferral.

But who knows, Borzi's proposal might even be good for annuity issuers. Judging by the DoL's desire to see an income estimate on participant statements, the government likes annuities. Today, insurers are invoking fiduciary duty to persuade plan sponsors to offer income options in 401(k) plans. If the fiduciary standard were applied to the management of money in rollover IRAs, annuity issuers might use it to shame advisers into putting part of their clients' savings in annuities.