The Pros and Cons of 401(k) Annuities

By Editor Test *Thu, Sep 16, 2010*

One witness at the DoL/Treasury hearings this week asserted that mandatory annuitization of DC assets at retirement is needed. The government, as well as sponsors and plan providers, have largely ruled that out.

The prominence of the witnesses testified to the significance of the DoL/Treasury Department hearings this week on so-called "401k annuities" and other tools that can help plan participants turn their savings into income–either while they save, when they reach retirement, or in retirement.

Delegates from the retirement industry's A-list made statements, including (in addition to those mentioned in today's cover story) JP Morgan, TIAA-CREF, Lincoln Financial Group, Great-West Life, Dow Chemical, Honeywell, Hueler Companies, Vanguard, Nataxis Global Asset Management, Financial Engines, and consultants Towers Watson, Milliman, and Hewitt.

Many of these companies have introduced in-plan income products already. TIAA-CREF pioneered the group variable annuity in the 1950s. Vanguard and Hueler announced an agreement last week to give Vanguard IRA owners access to Hueler's online SPIA supermarket, which provides institutionally priced income annuities to participants in 1,200 plan.

Prudential Retirement and Great-West offer stand-alone guaranteed lifetime income riders to participants with target-date funds. Financial Engines expects to offer an in-plan option in late 2010 or early 2011. Asset managers Vanguard, Fidelity, Putnam and Russell all sell payout mutual funds, which deliver predictable but non-guaranteed income streams.

Trade, labor, and consumer advocacy groups also contributed their thoughts. The AFL-CIO, the Investment Company Institute, the Profit-Sharing and 401(k) Council of America, the American Council of Life Insurers, the American Society of Pension Professionals and Actuaries and the Spark Institute all gave testimony. Other groups and firms can contribute statements via e-mail over the next month.

Some witnesses praised in-plan annuities, while others, like Steve Utkus of Vanguard, tried to bury them. To be sure, there are plenty of good reasons for putting income options in plans, either as savings vehicles (deferred annuities) or exit options (immediate annuities, payout funds).

Big plan sponsors have economies of scale and bargaining power that lower the costs of products, administration, and education. Plan sponsors are also in a unique position to set up a program that applies the employer match to the purchase of future income—a path that MetLife and Mutual of Omaha are pursuing. Like contributions to a defined benefit plan, that kind of program would leverage the time value of money and mitigate the interest rate risk and timing risk associated with the lump sum purchase of an annuity at retirement.

Counter-arguments

But there are plenty of many counter-arguments for putting annuities in DC plans. For plan sponsors, there are potentially huge expenses associated with evaluating the costs and benefits of different income product vendors and in educating employees. Above, all liability for picking the wrong provider or for giving employers bad (in retrospect) advice scares them. “Fiduciaries are paranoid and rightly so,” says Sheldon Smith, an ERISA attorney and president of ASPPA.

As for participants, most of them won’t retire from their current employer/plan sponsor. From the participant perspective, the average person spends only 4.2 years in any particular job and might participate in several 401(k) plans. There are also portability issues. Participants may want to change employers or get out of income products. Employers may want to change annuity providers.

Adapting recordkeeping systems to multiple income options, or options that might change suddenly, could also pose problems, especially for small employers. Ninety-percent of plans have fewer than 100 participants. Only the largest 10% of plans, which account for 85% of all participants, may be able to cope with the legal, educational, and recordkeeping challenges of in-plan options.

Other problems: most 401(k) accounts, even at retirement, are too small to annuitize at all, let alone big enough to allow for the ideal solution: partial annuitization. Annuity purchases can also trigger the need for spousal approval, potentially increasing paperwork for sponsors. Gender-neutral pricing rules in 401(k) plans also mean that retail annuities, which have gender-specific pricing, can offer men much higher payout rates than in-plan annuities.

Alternate vision

The zeal for putting guaranteed income options in DC plans is limited mainly to insurers. Asset managers like Vanguard and Fidelity, which are the custodians of millions of rollover IRAs, believe that most people will consolidate their tax-deferred savings in an IRAs and then buy an annuity—or simply take systematic withdrawals. Investment advisors think along the same lines, and millions of Americans are likely to take this path.

Even if you build in-plan annuities, will they come? There’s a lot of disagreement over whether Americans want in-plan annuity options. Even in DB plans, 90% of retirees who have the option choose lump sum payouts over lifetime income streams. Shlomo Benartzi of UCLA, and an Allianz Life consultant, cited evidence of high annuitization rates in some companies, and MetLife said participants like a partial annuitization option. But the evidence is inconsistent. Most people don’t want to give up control over their assets or even part of their assets, especially not at time they stop working, when their retirement plans are still unsettled.

There’s also the crowding-out problem. Thanks to Social Security, most middle-class plan participants will get at least half of their retirement income coming from an annuity, and have no compelling reason to annuitize their DC savings. On the contrary, they may need their DC assets to stay liquid for emergencies, bequests, weddings or simply long-deferred pleasures.

To overcome this resistance or inertia, some witnesses said, the government might have to approve a qualified default annuity option, analogous to auto-enrollment and the qualified default investment options in 401(k) plans. One witness, Josh Shapiro of the National Coordinating Committee for Multiemployer Plans, asserted that nothing short of mandatory annuitization of DC assets at retirement will really change the game. The DoL and Treasury, as well as sponsors and plan providers, have already ruled that out.