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Annuities in 401(k) Plans:

What a Plan Sponsor Should Keep in Mind

by | **Thomas M. White**

Interest is growing in providing an annuity product in 401(k) plan offerings—not a popular option with participants. Plan sponsors must consider many factors and ask many questions before and after deciding whether to offer annuities.

Recent reports indicate that many U.S. workers believe that they will have to postpone retirement because they have insufficient assets to provide for a comfortable income during retirement. A number of factors make this a reasonable concern, including:

- The relative decline in coverage by defined benefit pension plans offering guaranteed benefits beginning at retirement and extending for life
- The increased use of 401(k) plans under which benefits are based on fluctuating investment returns
- The poor investment returns provided in the recent past by equity markets and low long-term interest rates
- Increasing longevity, which means that individuals' investment portfolios (whether inside or outside 401(k) plans) will have to last for longer periods than previously anticipated
- Low savings rates.

continued on next page

takeaways >>

- Annuities can address concerns about the adverse impact of longevity, inflation and becoming incapable of managing investments.
- Few 401(k) plans provide annuities because participants aren't interested in them, they create administrative issues, and employers worry about fiduciary risk.
- Plan sponsors may need professional help from attorneys and consultants in analyzing annuity products.
- Fees, communications to participants and valuation of account balances require careful consideration.
- Fiduciaries must understand the investments they offer and determine, periodically, whether the annuities they offer continue to be a prudent choice.

Typically, we have thought that retirement benefits will be provided through a combination of Social Security benefits, employer-sponsored retirement plan distributions and personal savings. There are two major risks that retirees and potential retirees have typically recognized in the past: that they will outlive the length of their benefit streams (*longevity risk*) and that inflation will erode their purchasing power (*inflation risk*). Many people have overlooked a third risk—that as they age, their capacity to manage their investments will decline (*incapacity risk*). Obviously, the longer one lives, the greater the adverse impact of longevity, inflation and incapacity.

Annuities address several of these concerns because they provide benefits over a lifetime, anticipated payments may increase over time and they may not require purchasers to constantly adjust their investment portfolios. Because of these characteristics, some employers are adding annuities to their 401(k) plan investment offerings. The Department of Labor (DOL) and the Treasury Department are examining whether retirement plans should be required or encouraged to provide plan participants with annuity choices.

However, few 401(k) plans provide for annuities. Plan sponsors have been reluctant to expand their menus of plan investments to cover annuities primarily because there has not been significant interest by participants, there are additional administrative issues and employers are uncomfortable with the possibility of fiduciary risk. In particular, employers and fiduciaries are concerned that they may be sued if the annuity carrier is unable to satisfy its obligations over extended periods of time.

Annuities are not popular with plan participants. Studies have shown that most participants prefer lump-sum distributions, rather than annuities, in part because of the complexity of annuity products. It is also possible that participants recognize that the stream of payments that annuities provide is based on the carrier's anticipated investment performance. Because interest rates are low and other asset classes have performed relatively poorly over extended periods, currently an investor would have to pay a considerable amount for a given level of future annuity payments.

Annuity carriers and investment firms have designed new annuity prod-

ucts with the 401(k) plan market in mind. Interests in these annuities may be acquired as each plan contribution is made. This means that a participant may make a series of acquisitions over the term of his or her plan participation and have the benefit of dollar cost averaging as interest rates and other factors change over time. These annuities also vary based on whether they are fixed for the term of distribution or take into account inflation or investment performance.

Analyzing Annuity Products

Because annuity products are complex and new ones are being developed, plan sponsors would be well-advised to obtain professional assistance from benefits counsel and consultants in the acquisition and review process. Consulting firms that offer assistance regarding mutual fund selections may not have the expertise necessary to analyze annuity products.

The first decision a plan sponsor needs to make is whether annuities as a class of investments is appropriate. If the answer is yes, then a selection must be made from among the available products. Several features need to be analyzed.

The fees charged by annuities tend to be considerably higher than those charged by other investment products. In this regard, it should be noted that the death benefit under an annuity may be more costly than similar coverage charged by group term insurance policies. The additional costs associated with annuity contracts will reduce the amount available for investment.

Appropriate participant plan communications are necessary, but inherently complex. It is difficult to describe

to participants the ultimate benefit that an annuity will provide if the benefit may fluctuate due to future purchase rates, investment returns or inflation.

This problem will be compounded if the plan changes the carrier in the future. For example, assume that a plan annuity provides that a future benefit stream is acquired as each plan contribution is made and that a participant will purchase an annuity over the course of his or her career. The benefit that will be provided at a future time will vary depending on possibly hundreds of annuity acquisitions. Not only may each of the purchase rates differ, but so may the interest earned and rates of interest that may be credited. DOL and the Treasury need to assist employers in devising a descriptive format that employers can rely on when providing meaningful and understandable information to participants.

The valuation of account balances on a periodic basis is critical for 401(k) plans, and plan sponsors need to assure themselves that each annuity can be valued accurately and promptly. For example, plans report the value of their assets each year on their annual report—Form 5500—and completion of this form will require timely and accurate information from each annuity carrier.

Accurate and timely information is also important at the plan participant level. A number of events will require carriers to be able to report the value of their annuities frequently, often at unanticipated times. For example:

- Many plans permit participants to borrow from their plan accounts and the maximum amount of the loan may be limited by the size of the participant's account.
- Plan participants may get divorced, and their spouses may be entitled to a specified percentage of their accrued benefit.
- Participants may decide not to withdraw their entire account balance upon termination of employment or retirement. These individuals may be required to receive an annual minimum distribution based in part on the value of their account balance.

In each of these instances, each annuity that the participant has acquired must be valued. These valuations need to be prepared in a timely manner. For example, a participant requesting a plan loan may wish to borrow the maximum permissible amount and the person responsible for administering the loan program may decide not to rely on months-old valuation data.

Moreover, these valuations need to be provided for each

annuity held by the plan. This may prove difficult to obtain if the annuity carrier has no current relationship to the plan because its contract terminated, perhaps decades in the past.

The appropriate forfeiture of invested amounts may raise administrative issues. This concern may be avoided by permitting annuity acquisitions only by participants who are fully vested. An example highlights the administrative issues that may arise. John Smith, a plan participant, terminates his employment when he is 50% vested in his account. Under the terms of the plan, his nonvested account balance will be forfeited and the forfeited assets will be reallocated to the remaining plan participants. A number of questions need to be answered: Will the annuity permit a reallocation to others prior to the time that the participant would be entitled to a distribution? How will this forfeiture be invested between the date that the participant terminates employment and the date of reallocation? If Smith returns to employment and coverage under the plan, may additional sums be invested in his annuity or will he permanently be disadvantaged due to the prior forfeiture?

Termination Issues

Termination issues at both the participant level and the contract level need to be addressed. Upon termination of employment, a plan participant may find that a new employer's plan does not accept the rollover of an annuity contract. Individual retirement accounts (IRAs) may also not be available to the recipient of an annuity rollover. This lack of portability may be a significant detriment to participants and should be explained in appropriate communications.

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401(k) Answer Book

by Steven J. Franz, Lisa R. Richardson, Joan C. McDonagh and Marilyn R. Collister. Aspen Publishers. 2011.

For more details, visit www.ifebp.org/books.asp?8862.

Moreover, the annuity contract should be analyzed to determine what occurs upon termination of the contract by the plan. It is quite possible that such contracts will be terminated if, for example, few participants acquire annuities or if appropriate plan fiduciaries determine in the future that other annuities provide better features, perhaps at a reduced cost. Will participants incur a charge? Will they be able to liquidate their annuity investment and under what conditions?

Fiduciary Responsibility

If the administrative and practical issues have been resolved favorably, then the plan sponsor needs to determine which annuity or annuities may be acquired from the myriad products available to the plan. Employers have been reluctant to offer annuities in their plans for several reasons. One of the paramount reasons is the fiduciary risk that comes with offering any plan investment. The Employee Retirement Income Security Act (ERISA) mandates that plan fiduciaries act prudently in selecting plan investments and that plans may pay no more than reasonable fees for the products and services they acquire.

With regard to prudence, fiduciaries

need to understand the features of the investments they offer and may need professional assistance in analyzing investment alternatives. Because annuities are long-term investments, fiduciaries need to determine the likelihood that the carrier will have the capacity to provide the benefit for the lifetime of young plan participants and their spouses. This could involve a period of 60 or more years. An annuity carrier selected today must have the capacity to perform all of its obligations for this extended period. DOL and the Treasury have been requested to develop safe harbor rules that will permit plans to acquire annuities based on current information. To date, new rules have not been issued.

Reliance on a rating from a rating agency will be insufficient to demonstrate prudence. Employers need to ask a series of questions and assess the answers.

- How are the annuity's assets invested?
- If it is invested in a series of funds, how are those funds selected?
- What happens if the annuity contract is terminated? Will there be a surrender charge? Will any surrender charge have a material ad-

verse effect on participant investments?

- When and under what conditions may annuity funds be liquidated and moved to alternative investment classes within the plan? This may be particularly relevant because an appropriate annuity today may not be the best one tomorrow, or at some future date.

ERISA also requires that the fees charged be appropriate and not excessive. Fiduciaries should determine the fees paid in connection with the annuities. Who gets what fee? How do fees vary from one annuity carrier to another? Could similar investment objectives be satisfied at lower costs or with lower risks? A death benefit is usually provided. Is the cost of the death benefit acquired through an annuity in excess of that charged under, for example, a group term insurance policy?

The analysis does not end when an annuity or any other investment is selected for a plan. The appropriate fiduciaries should determine, on a periodic basis, if a particular annuity remains a prudent choice. If alternative choices prove better, fiduciaries should consider terminating existing annuity contracts.

Although few employers have added annuities to their plan investment menus, more are curious. This interest should increase if the administration mandates availability of this asset class or if participants express strong interest in acquiring annuities. Careful analysis is required before employers proceed. **6**