Don’t Count Annuities Out

A response to the Department of Labor’s “Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans”.

Dietrich & Associates, Inc. is the leading expert specializing in the pension annuity market for corporate, non profit and public retirement plans. In the last four decades our firm has overseen thousands of defined benefit pension plans guaranteeing lifetime retirement benefits for several hundred thousand participants through the purchase of annuities that defease the plan obligation to financially sound insurance companies. Our firm has transferred more than $ 4 billion in annuity payouts from pension plans to annuity providers and not one retirement payment to participants has been missed or at risk of default.

A continuing trend of employers to move away from the traditional Defined Benefit pension plans towards 401k plans by offering lump sum payouts and freezing and terminating Defined Benefit pension plans has been obvious for the last several decades. Unfortunately, this trend has left current and future participants without a guaranteed Income for Life annuity benefit. This is a meaningful benefit that prior generations of workers relied on as their retirement income supplement to social security benefits. Because this lifetime income benefit is not typically offered in current 401k plans, all participant 401k asset balances are invested and are 100% “at risk” in the capital markets. Today’s 401k plan design leaves both investment and longevity risk to rest solely with the participant.

For these reasons, it is essential that an Income for Life benefit be made available once again to plan sponsors and participants as part of (or along side) existing 401k and other Defined Contribution retirement plans. Employers should be encouraged to direct their contributions toward an annuity benefit via safe harbor protection or other means and participants should be permitted the option of an “income for life” benefit for their contributions as well. (Offering a limited income tax exclusion would help incent participants to select an income for life payout) In addition, the annuity benefit being offered needs to be a “true” annuity where there is a guarantee of income for life via a contractual transfer of longevity risk to an insurer. This insurer must meet the qualifications under DOL 95-1 as “safest available” annuity provider or be measured within the same standards. Synthetic product offerings such as “target date” or “guaranteed withdrawal” schemes do not transfer longevity risk to an insurance company and should not be considered in this asset class for this reason.

Allowing lump sum payouts from the remaining Defined Benefit pension plans where participants can opt out of the life income benefit also needs to be reviewed and modified. Our experience has been that nearly all (90+%) of retirees already receiving life income payouts elect to continue them even when offered a lump sum subsequently. When lump sums are offered prior to retirement, approximately 90+% elect a lump sum, a completely opposite result. This may be due to several reasons; a) they have not become accustomed to the security of the lifetime income stream having never received them, as current retirees have, b) because it is human nature to select cash today as opposed to an Income for Life annuity in the future or c) because the election has to be all in one form or the other requiring participants to make all or nothing choices among options. Regardless of the reasons, communicating to and allowing participants the ability to elect a portion of their distribution among both the lump sum and the life income payout (however they wish) would increase the likelihood of participants selecting the annuity payout benefit for, at least, a portion of their distribution. This will require additional communication to participants about their choices but would be well worth the effort.

Participant understanding needs to be expanded and improved through education at the employer level so that participants become better informed about saving, investing and the guarantees that various “insured” financial assets can provide. Income for Life annuity options (life, joint and survivor) need to be recognized for the features they provide and the risks (both tangible and intangible) that they mitigate for the participant and their spouses (for example, surviving spouses need not be concerned with making investment decisions). An Income for Life annuity is as much an insurance policy as it is an investment and needs to be viewed as such.

Annuities have been around for centuries, in fact, many early retirement plans were funded solely through the use of immediate and deferred payout annuities. To suggest that an annuity option shouldn’t be provided as a base level of benefit (at the very least) in today’s’ 401k era would be to ignore the fact that historically, Defined Benefit retirement plans have served retirees well by guaranteeing a valuable benefit they cannot outlive. Opponents of payout annuities provide various reasons why they would never “own” one, however there are counter points for every argument. The fact is that the annuity takes unpredictability and makes it predictable. It accomplishes this by contractually transferring risk away from the participant in a 401k plan and away from the plan sponsor with defined benefit pensions. This is a good thing in that it provides an effective hedge against the risk and volatility inherent in the other asset classes they are invested in.

We would be pleased to offer the DOL more specific insight and guidance on how best to position and implement annuity solutions in today’s retirement plans where 401k plans are now the primary retirement vehicle for most participants.

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