Is a Lifetime Income Option Right for Your 401(k) Plan?

A Brief Overview of the Fiduciary Process for Prudent Selection

EXECUTIVE SUMMARY

As we live longer and healthier lives, it is important to plan for longer and financially healthy retirements. Employer-provided, defined contribution retirement plans, such as 401(k) plans, are an essential component of retirement planning for millions of Americans. Many participants and plan sponsors are beginning to take a fresh look at their 401(k)-type plans to see how they might be improved to provide better retirement security, and are considering whether a lifetime income option might be appropriate for their plans.

Similarly, Congress and officials at the Treasury and Labor Departments are reviewing current laws and regulations governing retirement plans to determine what changes would improve the ability of workers to manage their retirement savings and retirement income needs. Given the complexity of the law and regulations, and the variety of products and strategies available, making decisions regarding lifetime income options can be difficult for both plans and participants.

Lifetime income products come in a variety of forms with significant differences in features and costs. Some merely provide guaranteed income in retirement and are purchased at or near retirement. Others are comprehensive products designed to assist participants in accumulating retirement assets while working, and then in using these assets to provide lasting income after retirement.

For retirement plan fiduciaries (the decision-makers for the plan who exercise discretion over plan administration and plan assets), the decisions to offer a lifetime income feature and to select a particular product are fiduciary acts under the Employee Retirement Income Security Act of 1974 (ERISA).

By law, these fiduciaries must make a prudent decision, taking into account all relevant factors, including the needs of the plan participants, the types of lifetime income products available, the costs of such products, the portability of such products if participants change jobs, and any penalties, restrictions, or limitations on such products. If the fiduciaries are considering annuitized lifetime income products, they must also evaluate certain factors relating to the solvency of the insurer and its ability to meet these future obligations, as well as take into account how such options might result in new administrative duties under the qualified joint and survivor annuity rules.

In prudently making these decisions, fiduciaries are obligated to act solely in the interests of the participants, and must pay only reasonable fees. Fiduciaries are personally liable for making whole the plan and its participants for any losses that result from breaching these important legal duties.

This white paper discusses some of the primary fiduciary considerations associated with selecting a lifetime income option, as well as some of the salient characteristics of the...
different types of products. While this summary is a helpful guide for fiduciaries to educate themselves about how to begin to evaluate adding a lifetime income option to their plans, it cannot be relied on as legal advice for a particular plan, as the fiduciary decision must be based on the specific characteristics of each plan and of each option under consideration. Fiduciaries should seek legal counsel or other appropriate expertise to ensure their compliance with the law and the fiduciary decision-making process.

INTRODUCTION

There are many risks we seek to guard against in planning our retirements that require carefully balancing competing needs. We do not want to outlive our savings, but neither do we want to significantly reduce our standard of living when we retire. In anticipation of a long and healthy life, we want to ensure that our savings will continue to grow through prudent investments even after we retire, but we don’t want to expose ourselves to unnecessary market risk that might significantly reduce our savings near or after retirement. We want the security of knowing our stream of income in retirement will be sufficient and steady, but we also want the flexibility to be able to take a dream vacation or to meet a major unexpected expense. We may also want to ensure that our loved ones benefit from assets we don’t consume in our retirements.

Managing the retirement (or distribution) phase of retirement savings involves more than just starting to spend the assets accumulated. Other key factors include determining how much annual income will be needed during retirement, how long that income is needed, how to ensure the financial flexibility to meet unexpected expenses, and how to balance the need to begin consuming savings with the need to ensure savings will continue to grow and last for 20, 30, or even more years after retirement.

While recent changes to federal law and regulation facilitate the accumulation phase of retirement, such as automatic enrollment and Qualified Default Investment Alternatives (QDIAs), the situation is less clear for the distribution phase of retirement. As a result, many plan fiduciaries are uncertain how to best evaluate lifetime income options that could be adopted by their plans.

There is an increasingly broad array of lifetime income products available as financial service providers of all kinds seek to offer products that both appeal to plan participants and address concerns of plan fiduciaries. Some products utilize annuities while others do not. These different products present different issues fiduciaries must analyze in making a prudent selection.

WHAT ARE THE LEGAL DUTIES OF THE PLAN FIDUCIARY?

401(k)s and other types of retirement plans sponsored by private-sector employers are governed by the Employee Retirement Income Security Act of 1974 (ERISA). ERISA is designed to protect participants in these plans by imposing very strict legal duties on plan fiduciaries, the people authorized to make decisions on behalf of the employer’s plan and its workers. These fiduciary duties are defined both in statute and regulation. The Employee Benefits Security Administration (EBSA) at the U.S. Department of Labor (DOL) is the federal agency responsible for issuing regulations and guidance regarding ERISA’s fiduciary requirements, and EBSA has issued a number of regulations relevant to the process by which a fiduciary evaluates lifetime income options.

The law requires fiduciaries to act “solely in the interest of the participants and beneficiaries” of the plan “for the exclusive purpose of providing benefits…and defraying reasonable expenses of administering the plan.” Fiduciaries must do so in accordance with the law and “the documents and instruments governing the plan.”

While each plan must have a one or more “named” fiduciaries identified in the plan documents with authority to make decisions on behalf of the plan, the named fiduciary may delegate some of its authority to one or more additional fiduciaries. For example, a named fiduciary might delegate the authority to make plan investment decisions to a fiduciary investment manager. If the delegation is made properly, the named fiduciary is responsible for selecting and periodically monitoring the activities of the investment manager, but the investment manager, not the named fiduciary, is responsible for the plan’s day-to-day investment decisions.

1 ERISA §404(a)(1)(A)
2 ERISA §404(a)(1)(D)
3 See ERISA §402(a)
4 As this example illustrates, a named fiduciary can never delegate all of its authority and liability—the named fiduciary always retains the duty to prudently select and monitor the activities of those fiduciary and nonfiduciary providers it hires to carry out the plan’s business.
Fiduciaries must carry out their responsibilities “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise with like character and like aims.”

EBSA regulations interpreting the law explain that the fiduciary, when selecting investments for the plan, has met the prudence requirement if the fiduciary “has given appropriate consideration to those facts and circumstances that…the fiduciary knows or should know are relevant to the particular investment or investment course of action involved…[and] has acted accordingly.”

In practice, being a prudent fiduciary is a function of employing an objective, thorough, and analytical process. The “prudent man standard” of ERISA is concerned with the process by which a fiduciary reaches a decision. Did the fiduciary gather the information necessary to consider all of the relevant factors? Did the fiduciary determine whether it possessed the necessary expertise to evaluate the relevant factors, and seek outside advice or assistance as necessary? Did the fiduciary then make a decision based on this information and analysis?

The prudent process is specific to the particular facts and circumstances of each investment decision. Common factors to consider include the costs associated with the investment, how the investment option fits within the plan’s overall investment strategy, how the investment option suits the needs of the plan’s participants, the past performance of the investment, any restrictions or additional fees the investment imposes when entering or leaving the investment, and whether such an investment is permitted by the plan documents. However, the relevant factors will not be the same for all potential plan investments, because the investments will have different goals, features, and cost structures.

Over the years, EBSA has provided additional regulations or guidance regarding particular types of investments, often directing fiduciaries to consider specific characteristics of those investments. When evaluating whether to offer a lifetime income product, and when choosing among the various types of products available, fiduciaries should be aware that EBSA has issued specific guidance relevant to certain lifetime income products.

THE FIDUCIARY CONSIDERATIONS OF OFFERING A LIFETIME INCOME PRODUCT

When deciding whether to offer a lifetime income product, fiduciaries need to employ a prudent process to assess whether doing so will be in the best interests of the plan participants. They then must evaluate the merits of the different products available. While this determination must be specific to each plan, the following are some generally relevant considerations.

The fiduciary should first understand some of the basic differences between the kinds of lifetime income options available. One of these issues is whether the product is using insured annuities or a non-annuity investment strategy to provide retirement income. While there is significant variation within these categories as providers continue to innovate and develop new products, the basic question of whether an annuity is used is very relevant to a fiduciary analysis of the lifetime income option, its features, and its costs.

PARTICULAR FIDUCIARY CONSIDERATIONS OF ANNUITIZED LIFETIME INCOME OPTIONS

Though there are a number of ways in which the fiduciary considerations of annuitized products differ from non-annuitized products due to differences in product design, fiduciaries should be particularly aware of issues related to the annuity provider’s financial condition, the application of the Internal Revenue Code’s qualified joint and survivor rules, and the portability of the option.

Insurer solvency—Over the years, DOL issued several guidance documents addressing how plan fiduciaries should consider the financial stability of a prospective annuity provider in different circumstances. The most recent and relevant of these is an elective “safe harbor” regulation addressing annuities in individual account plans, such as 401(k) plans. The regulation describes the steps a fiduciary may take to be deemed to have complied with his or her fiduciary duty. The safe harbor requires, among other things, that the fiduciary “appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments…[and] appropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract…[and] if necessary, consults with an appropriate expert or experts.”

1 ERISA §404(a)(1)(B)
2 29 CFR §2550.404a-1(b)
3 29 CFR §2550.404a-4.
While this elective safe harbor does not establish minimum standards or serve as the exclusive means to comply with one’s fiduciary obligations, it does clearly express DOL’s view that this factor is relevant.

The requirements of the safe harbor regulation were discussed in a 2010 joint hearing of the Department of Labor and the Treasury Department regarding lifetime income options. A number of witnesses, including insurers offering annuity-based lifetime income products, testified that because the safe harbor does not expressly allow fiduciaries to rely on insurance rating organizations as an objective measure of solvency, and because it is not clear when consultation with an expert is necessary under the rule, some fiduciaries have difficulty using the safe harbor. Witnesses also noted that it was not clear from the text of the regulation how the safe harbor applies to certain new types of lifetime income products.8

Qualified joint and survivor annuities—The qualified joint and survivor annuity rules protect the rights of spouses to at least half of the ongoing payments from annuities paid under qualified plans, such as traditional defined benefit pension plans. However, most 401(k) plans are designed to provide a fully vested spousal right to 100% of the participant’s account as the primary beneficiary. This primary beneficiary status prevents the plan from having to comply with the administrative complexities of special notices and election forms associated with qualified joint and survivor annuities. Depending on the type of annuity associated with the lifetime income option, a 401(k) might have to adopt the more burdensome rules in order to include the annuity feature in the plan. Fiduciaries should consider whether this compliance issue will arise, potentially increasing the administrative complexity and cost of the plan.

Portability—Fiduciaries should be aware of and consider any restrictions or limitations lifetime income options might place on participants who leave the plan. For example, it may or may not be possible for participants to maintain their guaranteed products by rolling over to an IRA or to a new employer’s plan if they leave their jobs. Fiduciaries should also consider what costs and difficulties they might encounter when changing service providers, such as recordkeepers. While many annuity-based lifetime income products are portable in the sense that they can be transferred from one recordkeeper to another, it appears, according to testimony received by the Departments of Treasury and Labor, that the products themselves may not be portable from one insurer to another. As a result, a decision to use an annuity-based product may result in a long-term commitment to a particular provider.

GENERAL CONSIDERATIONS OF SELECTING LIFETIME INCOME OPTIONS

Should it be a QDIA?—QDIAs are investment options into which the plan will automatically invest the participants’ funds unless participants provide alternative investment direction. Such arrangements are commonly used in connection with automatic enrollment of new workers into the company 401(k) plan. Providing the lifetime income option otherwise meets the requirements of the regulation, it can be selected as a QDIA. This approach has the benefit of providing a safe harbor for plan fiduciaries regarding liability for the investment outcomes of participants defaulted into the QDIA. However, DOL takes the view that the safe harbor does not absolve the plan fiduciary from the imprudent selection of an investment option, so the plan fiduciary must still employ a prudent process for selecting the lifetime income option.

Demographics of the plan—There is no fiduciary duty to offer a lifetime income option regardless of how much it might benefit the plan participants, but how adopting such an option will affect the participants is a relevant consideration for plan fiduciaries. For example, an older workforce might see significant benefit from certain types of lifetime income products, but these products may not be as advantageous for younger workers. Fiduciaries should take into account how lifetime income options might benefit or not benefit particular groups of plan participants.

Costs and fees—Fees and expenses are relevant factors for the fiduciary to consider, but they are one of the set of relevant factors, not the sole consideration. A fiduciary must determine that fees are reasonable, but a reasonable fee need not be the lowest bid received. However, the fiduciary does need to fully understand on what basis the fees are being charged, and for what services. Given the wide variation in types of lifetime income options, fiduciaries should take care to fully understand and consider the different fees for different purposes presented by different types of products.

Further, fiduciaries should consider what fees might be charged to plan participants who move into or out of the lifetime income

option. Some options might charge surrender fees or otherwise restrict or penalize participants who change options or engage in certain transactions within a specified time period. These restrictions may be appropriate and common, such as restrictions by mutual funds aimed at preventing market timing, but fiduciaries should understand when, why, and for how long they might apply.

Complexity, participant education, and the new fiduciary participant disclosure requirements—Lifetime income options can be complex financial instruments, and it is important that workers understand what they are investing in. While fiduciaries must, of course, provide the information and disclosures required by law and regulation, fiduciaries should consider educational programs with their providers to help participants better understand lifetime income funds and how they work.

Fiduciaries should take special note of a new fiduciary duty to disclose information to plan participants recently implemented by DOL regulation. For plan years starting on or after November 1, 2011, the plan administrator is required to provide participants with specific minimum disclosures regarding the plan and its investment options, and must ensure that a website with additional information is available to participants. The specific information required varies by product type and must be provided in a comparative format.

POTENTIAL LEGISLATIVE AND REGULATORY CHANGE REGARDING LIFETIME INCOME OPTIONS

In 2010, the Departments of Labor and Treasury issued a formal request for information and held public hearings to examine lifetime income issues. Congress has also held hearings on these issues. In these comments and hearings, many witnesses called for legislative and regulatory changes, as well as additional federal agency guidance, to facilitate the growth of lifetime income options of all kinds.

It is not yet clear what may emerge from this process, but both federal agencies and members of Congress have discussed whether to establish a methodology plans could use to show participants the retirement income their current account balances would produce. The intent of these proposals is to shift the emphasis during working and saving years from “accumulation” to “income.” Whether such a projection would be required for plans or how the projection might be calculated are questions that remain to be answered. It is clear, though, that there is considerable public policy interest in looking at lifetime income options as a means to improve the retirement security 401(k) and similar plans offer to working Americans.
CONCLUSION

In the defined contribution system, participants often need assistance in planning for a retirement that will include adequate retirement income. While some of this need can be filled with investment education or advice, many plans are beginning to evaluate whether lifetime income options can help workers achieve better results than workers will likely achieve on their own. Lifetime income options can offer significant benefits to participants by helping to ensure that retirement savings can last through retirement. However, these can be complex financial instruments that come in many variations with significantly different fiduciary considerations.

Plan fiduciaries need to ensure they are employing a prudent and well-documented process that takes into account the specific facts and circumstances of their plan when evaluating lifetime income products. While many considerations are similar, there are material differences in factors fiduciaries need to consider when comparing annuitized and non-annuitized lifetime income products. Both can be excellent choices for plans, but fiduciaries need to evaluate their plans, their participants’ needs, and the available products very carefully through a thorough and analytical process to make a prudent selection.
Bradford P. Campbell is a nationally recognized figure in employer-sponsored retirement, health, and other welfare benefit plans. From 2006 to 2009, he served as the Assistant Secretary of Labor for Employee Benefits, the head of the Employee Benefits Security Administration (EBSA). As ERISA’s former “top cop” and primary federal regulator, Mr. Campbell provides his clients at Schiff Hardin LLP with insight and knowledge across a broad range of ERISA plan-related issues.

While in public service, Mr. Campbell played a key role in the significant ERISA retirement and health plan reform efforts of the prior decade, and his regulatory and policy decisions had a fundamental impact on the structure and operation of ERISA plans. Mr. Campbell orchestrated implementation of the most sweeping changes to pension regulations in 30 years, issuing nearly 30 regulations and major guidance documents, including final regulations establishing qualified default investment alternatives (QDIAs) to facilitate automatic enrollment in defined contribution plans; requiring electronic disclosure of more transparent plan expense and fee information; and improving participant access to professional investment advice.

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