The SECURE Act and Annuities

March 2020

DeMarche

The SECURE Act and annuities – What does it mean for plan providers?

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Annuity: *a financial product that pays out a fixed stream of payments to an individual, primarily used as an income stream.*

Point of Discussion

01 What is the SECURE Act?

02 What can annuities provide?

03 What does this mean for Plan Providers?

04 How can interest rates affect annuities?

Safe Harbor: *a legal provision to reduce or eliminate legal or regulatory liability in certain situations as long as certain conditions are met.*

The recent passing of the SECURE Act allows defined contribution plans to add annuities as a retirement option.

What is the SECURE Act?

The Setting Every Community Up for Retirement Enhancement (SECURE) Act is a bipartisan bill designed to aid Americans' ability to save for retirement. The bill, signed into law in December 2019, was drafted to address Americans' difficulty in saving and investing for retirement. A 2019 study by Northwestern Mutual found that 22% of Americans have less than $5,000 saved for retirement and 15% have no retirement savings at all. Given longer life expectancies than previous generations, coupled with the rate of inflation, a minimum balance of $1 million is recommended for retirement accounts by the date one plans to stop working.

The bill permits certain tax-preferred pension plans to make a direct trustee-to-trustee transfer to another employer plan or IRA of lifetime income investments in the form of a qualified plan distribution annuity, if a lifetime income investment is not available as an investment option in a plan.

The bill also provides a safe harbor for plan providers in the selection of an insurer for a guaranteed retirement income contract. The provision is designed to help relieve plan providers' responsibilities in selecting and reviewing annuity providers, in addition to easing the burdens of getting an annuity solution into defined contribution plans. The provision would allow them to meet their fiduciary requirements if they choose an annuity provider who is in good standing with state and or federal regulators. This means that under the new law, there is less risk of being sued if the insurer selected to make annuity payments goes bankrupt and can not pay claims.

What can annuities provide?

Adding an annuity option to a retirement plan is thought to help participants mitigate longevity risk, which is the risk of outliving retirement savings. Studies show that the fundamental uncertainty about the length of one's lifetime can lead people to overuse their savings early in retirement, and thus having a predetermind income stream is a key benefit of an annuity. Other characteristics of annuities may include reduced investment risk, reduced interest rate risk, and potential inflation protection.

To ensure participants have access to a guaranteed income stream upon retirement, plan sponsors are adding annuities to defined contribution plans, also known as an in-plan deferred income annunity (DIA).

Deferred Income Annuity (DIA): *a contract between an individual and an insurance company. You give a lump-sum payment to the insurance company in exchange for guaranteed lifetime income that begins at a future date.*

Many different annuity products are available, ranging from those that are fixed in nominal terms, vary over time, or depend on the insurance company's overall experience regarding asset returns and mortality. Fees on annuities can be high compared to more traditional retirement plan options, so it is important to seek out products from institutional providers who offer competitive fee structures and terms.

A study conducted by The Brookings Institution shows that allocating 10% of a participant's assets to a DIA provides these participants with the potential to save less, yet consume substantially more, particularly at older ages. To ease the difficulty of implementing a default longevity income annuity into a retirement plan, sponsors could direct employer contributions directly to the DIA. By defaulting a portion of retirees' portfolios into deferred income annuities, plan sponsors can provide a lifetime income stream for workers in defined contribution accounts, partially filling the gap left by lack of defined benefit coverage in the private sector.

What does this mean for Plan Providers?

Many employers have expressed concern that their workers may be unable to manage their retirement assets sensibly when taking their assets out of their employer-sponsored plans. Truthfully, many retirees would actually do well to retain their funds in the lower cost investment options offered by the plan sponsors' defined contribution plan. Often, plan sponsors encourage this to help cut costs for all plan participants and retirees. Adding a DIA option to the defined contribution plan investment lineup could allow a participant to access a higher quality, lower fee annuity than they could likely access on their own after they've retired.

Despite safe harbor provisions provided to plan providers by the SECURE Act, proper due diligence should be observed when selecting an annuity provider. The main factor to assess is whether the annuity provider will be able to fulfill its obligation to pay lifetime income to retirees. Prudence will dictate that the insurance company offering the annuity has strong financial strength and retains a high credit rating from multiple agencies. Other important factors to consider include liquidity, death benefits, flexibility for income start date, ability to surrender and surrender charges. Lastly, it will be important to compare how the annuity's fees and payments compare to others. The decision to add an annuity option is ultimately the responsibility of the plan sponsor acting as a fiduciary. Annunities are an additional investment option to consider during plan design.

How can interest rates affect annuities?

In terms of the relationship between annuities and interest rates, one can certainly find a correlation. Fixed annuities generally move with rates, albeit with somewhat of a lag; however, there are a number of other factors involved: financial health of the insurer, structure and performance of their General Account, liquidity provisions, fees, surrender penalties (if any) etc.

In a study conducted by TIAA[2], they believe that the long-term risk-free rate would have to remain well below 1.5% or less for a significant amount of time for the value of the guaranteed rates on typical retirement annuity contracts to be worth more than the risk-free rate plus the TIAA credit spread. They quote that "during periods of low interest rates, we have observed a significant increase in the credit spread. As a result, the potential impact of the prolonged low interest rates has not impacted the valuation of the TIAA Traditional Annuity." TIAA also believes that while there is no guarantee what future crediting rates will be available to plan participants, past returns have normally been distributed over the measurement period relative to other observable risk-free or "low-risk" investments and market inputs.

Another factor both plan sponsors and plan participants should consider is the interest crediting method used by the annuity provider. This can be important because it determines how interest rate changes compared to a fixed index annuity are measured. The interest crediting method chosen measures the amount of interest that the annuity holder can receive over a specific time period, which could potentially limit the upside potential. The crediting rate can be determined, in part, by the net investment earnings rate of the assets supporting that particular interest rate bucket. Additional factors annuity providers may consider include targets for plan and participant servicing expenses, product costs (including amounts associated with managing and maintaining the General Account collateral portfolio), amounts set aside intended to cover risks and capital charges, and the general economic conditions when contributions are made.

Put Research To Work

with the DeMarche Team

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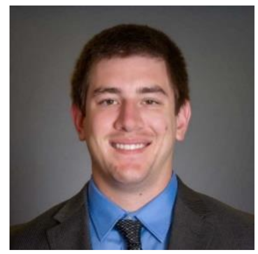

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Sources Utilized:

- *Automatic enrollment in 401(k) annuities: Boosting retiree lifetime income – a study by the Brookings Institution*
- *Principal Global Investors*
- *OneAmerica*
- *TIAA*
- *Northwestern Mutual 2019 Planning and Progress Study*
- *[1]Building retirement income into investment returns. TIAA Lifetime Income Survey, Sept 2019*
- *[2]TIAA Traditional Annuity: Adding safety and stability to retirement portfolios*