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Back to the Future: The Return of Fixed Annuities in Defined Contribution Retirement Plans

Presented by Multnomah Group and Moss Adams LLP

Housekeeping Items

- Presentation slides will be emailed to you by Friday

- To be eligible for CPE credit, you must:
  - Respond to at least 3 of the 4 polling questions
  - Attend for at least 50-minutes of the hour long presentation
  - If you have questions regarding your CPE credit, please contact Courtney Irvin at courtney.irvin@mossadams.com

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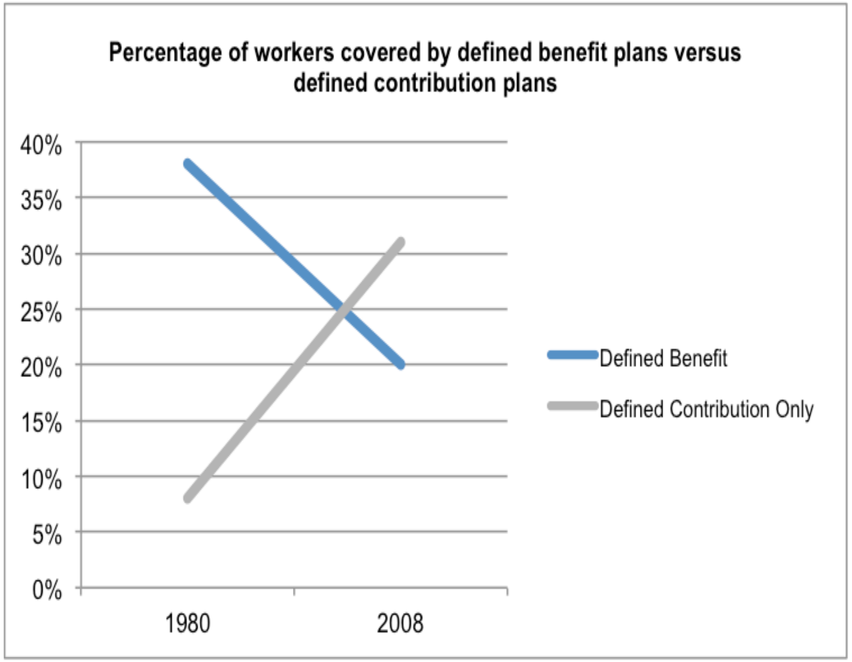
Agenda

- What are fixed annuities in the context of defined contribution plans?
- How should plan sponsors evaluate the costs and benefits of annuities?
- What considerations should plan sponsors have in communicating those costs and benefits to participants?
- How do annuities and annuitization impact the accounting and audit aspects of plan management?
- What is on the horizon for annuities in retirement plans?

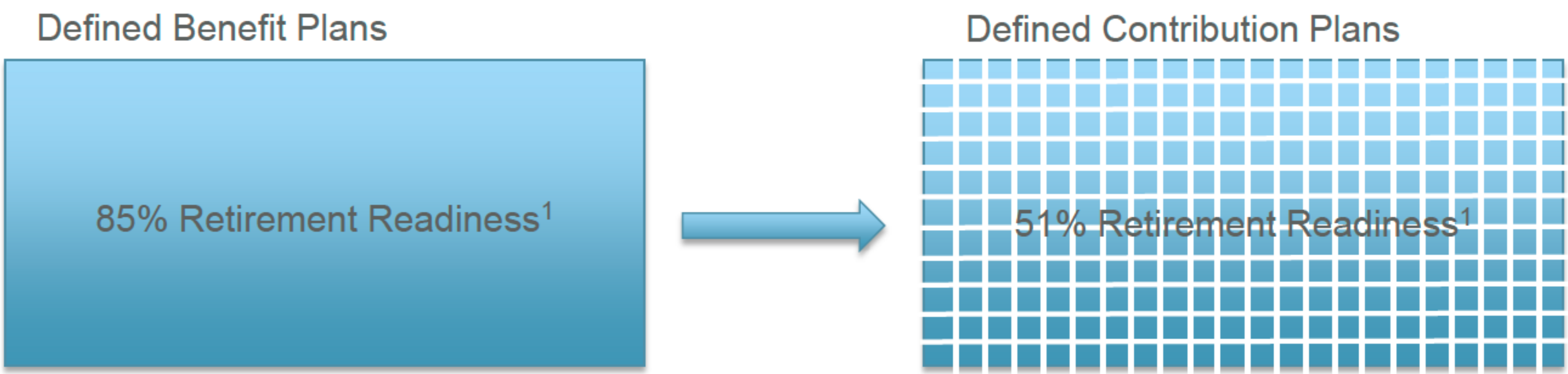
The World has Changed

- Defined Benefit pension plans are rapidly becoming extinct
  - For-profit
  - 501(c)3
  - Governmental
- Causes
  - Portability
  - Accounting requirements
  - Actuarial standards
  - Funding volatility
- Consequences
  - Risk transfer



Source: U.S. Social Security Administration, Office of Retirement and Disability Policy, "The Disappearing Defined Benefit Pension and its Potential Impact on the Retirement Income of Baby Boomers."

Change in Model for Retirement Savings



Primarily employer funded, with occasional required participant contributions	Funding	Mix of employer and employee contributions
Employer directed	Investment Strategy	Generally participant directed
Participants determine how much income they need to replace and work to the goal of achieving that level of benefit	Evaluation Metric	Participants focus on generating a sum of assets that will become the source of meeting retirement expenses
High	Plan Sponsor Volatility	Low
Participants are protected against investment and longevity risk	Participant "Safety"	Each participant must individually ensure their retirement preparedness

[1]National Institute on Retirement Security. *Retirement Readiness – What Difference Does a Pension Make?*

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Retirement Readiness in a Defined Contribution World

	Contribution Rate	Investment Return	Time Horizon	Retirement Income Needs
Participant Approach	Employers determine the contributions they make into participant accounts, but for the vast majority of defined contribution plans, those contributions need to be augmented by employee deferrals and supplemental savings. A participant's supplemental contribution rate is a critical element in the rate of success in retirement savings.	Participants in defined contribution plans select from available investments that ultimately determine the rate of return achieved on their savings and any contributions made by their employer.	DC plans have very little control over when a participant elects to retire. Plans are structured to permit participants to continue saving on a tax-deferred basis until they elect to retire or are terminated by their employer. Some participants may be incented to continue working past age 70 ½ to avoid IRS Minimum Required Distributions.	The degree to which savers have managed expenses well in their accumulation phase will impact their ability and willingness to retire. Fixed mortgage costs and eligibility for health benefits are significant variables in determining a participants income needs.
Challenge	Current Moment Bias	Gambler's Fallacy	Status Quo Bias	Negativity Bias

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Challenges for Defined Contribution Plans

- Participants view defined contribution balances in the context of wealth rather than income
  - Many participants are not aware of how much income their accumulations will provide
- Longevity risk
- Sequence-of-return risk
- Withdrawal rate concerns
- Inflation risk
- Cognitive risk
  - "Cognitive Impairment: Precipitous Declines in Cognition Can Set the Stage for Poor Decisions About Retirement Finances" David Laibson, Harvard University
- Market risk
- Health risk
- Agency risk
- Risk of error

Longevity Risk

For a 65-year-old man, there's a:

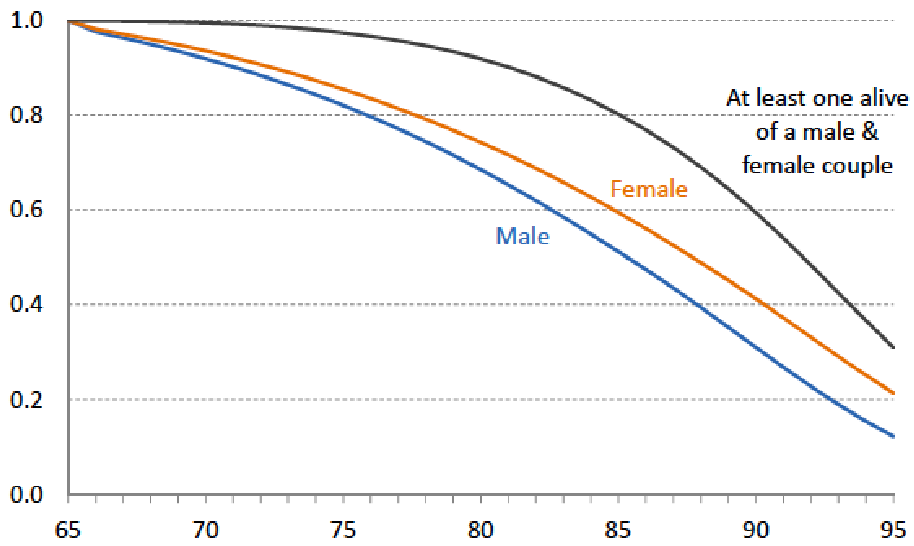
- 50% chance he'll live to age 85
- 30% chance he'll live to age 90
- 12% chance he'll live to age 95

For a 65-year-old woman, there's a:

- 50% chance she'll live to age 87
- 41% chance she'll live to age 90
- 21% chance she'll live to age 95

For a male and female couple, both age 65, there's a:

- 50% chance at least one will live until age 91, and
- 31% chance at least one will live to age 95

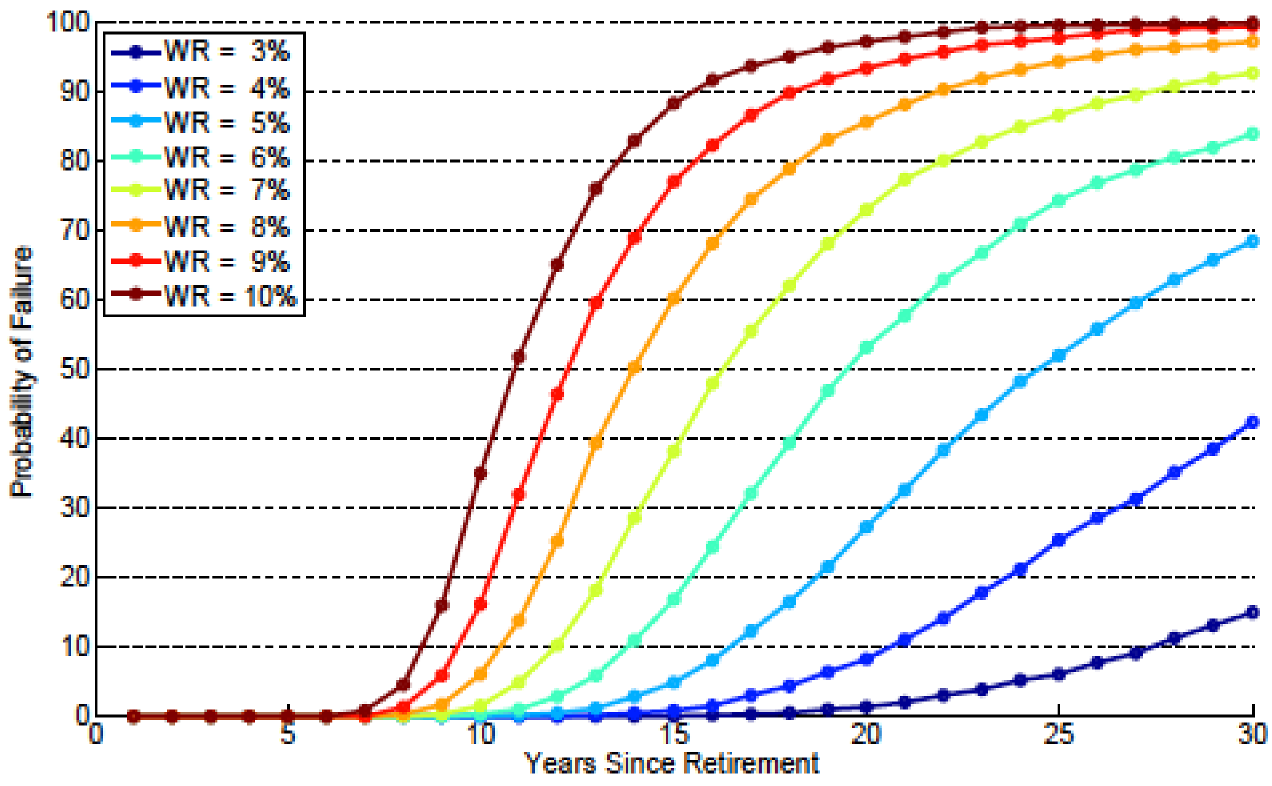


Source: RP-2000 mortality table projected to 2013 with Scale BB.

Withdrawal Rates

Probability of depleting assets over various time periods for different withdrawal rates.

- Portfolio invested 60% stocks / 40% fixed income



Dr. Wade Pfau, Professor of Retirement Income – The American College

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Types of Annuities in Retirement Plans

Variable – In a variable annuity, you can choose to invest your purchase payments from among a range of different investment options, typically mutual funds. The rate of return on your purchase payments, and the amount of the periodic payments you eventually receive, will vary depending on the performance of the investment options you have selected.

Fixed – In a fixed annuity, the insurance company agrees to pay you no less than a specified rate of interest during the time that your account is growing. The insurance company also agrees that the periodic payments will be a specified amount per dollar in your account. These periodic payments may last for a definite period, such as 20 years, or an indefinite period, such as your lifetime or the lifetime of you and your spouse.

U.S. Securities and Exchange Commission

www.sec.gov/answers/annuity.htm

Role of Annuities in Retirement Plans

Generate a stable return higher than that which is currently available through money market investments

Provide participants access to a method to convert accumulations into a steady stream of income

Considerations in Communicating Costs and Benefits to Participants

	Portfolio	Advantages	Disadvantages	Income Potential
Money Market Short-term, liquid, more secure avenue in which to park cash. Net of fee return is not likely to exceed the rate of inflation	Ultra-short bonds, treasuries, and commercial paper. Money market holdings in mutual funds are subject to strict federal guidelines	• Generally, the most secure and liquid place to store assets • Short-term portfolio responds rapidly to changes in the interest rate	• Participant misuse • Low returns, potentially less than inflation	Regular payments of variable amounts at timing determined by the participant
	Bank of America ML 3-Month T-Bill 5-Year Return 0.12%[1]			
Fixed Annuity Long-term, semi-liquid avenue to store a lower-risk portion of an asset allocation over the intermediate-term	Promise to pay from the issuing insurer backed by assets in the insurer's general account. Quality and security dictated by the state in which the insurer does business	• Should provide a higher crediting rate than money markets over full market cycles • Position is backed by the full faith and credit of the issuer • Future returns are generally announced in advance	• Participant misuse • Liquidity constraints • Difficult to analyze • Cost structure is generally not determinable	Income for life for both immediate and deferred fixed income annuities. Income is stated at purchase based on accumulated value and current interest rates
	Typical Fixed Annuity Return 2% – 4%[1]			

[1]Returns as of March 31, 2014

Plan Audit Issues

Valuation

- Fair Value Disclosures
- Able to be certified? Limited scope audit implications

Distributions

- How to verify accuracy of monthly payments?
- Eligibility of beneficiaries?

Reasons for Increased Interest in Adding Annuities to a 401(k) Plan's Investment Line-Up

1. Government wants to supplement Social Security and disappearance of Defined Benefit Plans

2. People are living longer, not saving enough, and outliving their retirement funds, causing a delay in retirement

3. Recent poor investment returns in equity markets, continued depressed interest rates

4. Government (specifically the DOL and Treasury) is studying if annuities should be required or only encouraged to be part of a plan's investment options

Why Aren't Annuities More Frequently Offered?

From a plan participant perspective:

1. No interest by participants and are perceived to be confusing
2. Expensive, high fees
3. Little trust in insurance companies
4. Participants prefer lump sum payments
5. Participant termination - can annuity be rolled into new employer's plan?
6. Portability, significant surrender fees to liquidate?

Why Aren't Annuities More Frequently Offered?

From a plan sponsor perspective:

1. Increased administrative issues
2. Increased fiduciary risk, what if annuity provider fails?
3. Is it an appropriate investment? What does plan population look like?
4. Long-term investment, possibly 50+ years
5. Communication with participant is complex and vital
6. Portability? What if plan changes custodians? Can annuity move without significant fees being charged?
7. How to determine accurate valuation at different dates? i.e., other than quarter or year end due to distributions

Availability of Annuities in DC Plans

1. In-Plan Annuity Products
    - Just 1% of plan sponsors offered an in-plan deferred annuity as an investment option to its participants[1]
2. Annuity as a Distribution Option
    - The prevalence of an annuity option in savings and thrift plans had fallen to 15% of participants by 2009[2]
    - Estimates are that only 10% of individuals with defined contribution plans annuitize their account balances when terminating employment at ages 60-69
3. Out-of-Plan Annuity Purchase

[1] *Annuities in the Context of Defined Contribution Plans – Deloitte 2011*
[2] *Bureau of Labor Statistics 2009 National Compensation Survey*

Guaranteed Income in Defined Contribution Plans

	Advantages	Disadvantages
In-Plan Annuity Products	• Can be used to accumulate future income units, create “income” mindset • Dollar cost averaging reduces point-in-time interest rate risk • May be attractive to older participants	• Selection is a fiduciary responsibility of sponsor • Long term risk associated with insurance providers • Recordkeeping challenges • Not all products allow free liquidity to exchange out • Portability issues • Lack of integration with participant tools and guidance programs
Annuity as a Distribution Option	• May provide institutional and gender neutral pricing • Department of Labor guidance from PPA	• Selection is fiduciary responsibility of sponsor • Long term risk associated with insurance providers • Very little participant usage where in place today • QJSA must be supported
Out-of-Plan Annuity Purchase	• Not a plan fiduciary oversight item • No cost to plan sponsor • Multiple vendors and products	• Separate from accumulation phase • Point-in-time rate risk for fixed income annuities • Participant decision may require commitment of significant portion of assets • Potentially higher costs

Value analysis of decumulation options for DC – Fidelity Investments May 2010

Challenges of IRA Rollover Annuitization

1. Annuitization is complicated
2. The individual assisting you is likely compensated based on the purchasing decision a participant makes
   - Variable and indexed annuities generally pay higher commissions than fixed annuities
   - There is little financially to be gained by “advertising” the benefits of low-fee or no-commission fixed annuities
3. Large financial commitment to spend accumulations for protection against outliving savings

Plan Sponsor Considerations in Annuitization

- The selection of lifetime income guaranteed products is a fiduciary decision
- Sponsors must assess the ability of the insurance company to meet its financial commitments in the future
- Fiduciaries must engage in a prudent process to reach an informed and reasoned decision
    - No different than the selection of other investment vehicles

Considerations

1. Financial strength of the company
    - Independent rating agency assessments
2. Product structure
3. Methodology for future crediting formula
4. Capitalization
5. General account investment structure and approach
6. Competitive position versus market alternatives

The Big Push for Participants to Choose Lifetime Income

Tons of proposed regulations from the Treasury Department and Internal Revenue Service

- Longevity Annuity Contracts, 77 Fed. Reg. 5,443 (proposed Feb. 3, 2012)
- Modifications to the Minimum Present Value Requirements for Partial Annuity Distributions Options Under Defined Benefit Plans, 77 Fed. Reg. 5,454 (proposed Feb. 3, 2012)
- Rev. Ruling 2012-3, 2012-8 I.R.B. 383 (2012)
- Rev. Ruling 2012-4, 2012-8 I.R.B. 386 (2012)

Is it lack of supply or lack of demand that is causing the lack of annuitization?

Proposed Legislation

Secure Annuities for Employees (SAFE) Retirement Act of 2013 proposed

- Senator Orin Hatch – R- Utah
- Would allow an annuity to be rolled into an IRA
- Unlikely to be passed soon

Q&A

Questions?

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