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Providing Guaranteed Lifetime Income Benefits: Managing Fiduciary Responsibility

Client Bulletin

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There is a serious risk that 401(k) and 403(b) plan participants will outlive their retirement savings. Guaranteed retirement income can address this risk; but in offering such a solution, fiduciaries need to understand their legal responsibilities and their advisers need to help them. Under ERISA and most state fiduciary rules (which would apply in the case of non-ERISA 403(b) plans), fiduciaries must prudently select the insurance company that provides those benefits. But despite a "safe harbor" regulation issued by the Department of Labor, fiduciaries have had little practical guidance about how to meet this obligation. In 2012, we issued a White Paper that addresses that problem by providing fiduciaries with a checklist of specific information to review.

Key Conclusions in the White Paper:

- Participants in 401(k) and 403(b) plans face a significant possibility that they will run out of money in their 80's or 90's.
- There are solutions that address this risk and provide retirees with a guarantee of lifetime income. Those guarantees can only be offered by insurance companies.
- Under ERISA and similar state laws, fiduciaries have an obligation to prudently select and monitor the insurance company that provides the annuity for the retirees.
- The process for selecting a guaranteed retirement income provider is fundamentally the same as for any other fiduciary decision, though the details of what to review will vary.
- A DOL regulation outlines the process for fulfilling this responsibility – but it offers little practical guidance on the information a fiduciary should review.
- We have published a practical, implementable checklist of information that fiduciaries can use to help satisfy the prudence requirement

Our White Paper, "Lifetime Income in Defined Contribution Plans: A Fiduciary Approach," was written with three goals:

- To discuss the risks that retirees face and the need they have for guaranteed lifetime income;
- To analyze the legal issues for the selection of a guaranteed lifetime income product and the insurance company that backs the product; and
- To provides a straightforward, practical checklist to help plan sponsors engage in a prudent process to select insurance companies that provide the guaranteed benefits.

An example that illustrates the need is longevity, that is, the fact that people are living longer…and, therefore, need more money to live on for a longer period. Actuarial studies show that for a couple, both age 65, there is at least a 25% probability that one spouse will live until age 95. (Indeed, some studies suggest that the probability may be as high as 50%.) If they retire at age 65, they need to plan on having their retirement funds last for 30 years. This often comes as a shock to participants looking at retirement.

The White Paper is partly an in-depth legal discussion and partly practical guidance garnered from industry experts in the insurance world. (In this connection, we want to specifically acknowledge the assistance of representatives of TIAA-CREF, who were most patient in helping us understand the intricacies of insurance company financial analysis.) We are not aware of any similar guides for plan fiduciaries and their advisers.

The DOL safe harbor regulation, Section 2550.404a-4, tells fiduciaries that they must "engage in an objective, thorough and analytical search," and must "appropriately consider" two key factors:

- "information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract" and
- the cost of the contract.

Unfortunately, the regulation does not provide fiduciaries with guidance on what information to use for the analytical search to be able to "appropriately conclude" that the provider will be "financially able to make all future payments."

The checklist provided in the White Paper is intended to fill that gap.

As the DOL indicates in the safe harbor regulation, the process described is not the only way to satisfy the requirement for prudently selecting the annuity provider. Similarly, we do not suggest that our checklist is the only path to a prudent process. The White Paper also does not establish a minimum. Rather, it lays out best practices for satisfying the safe harbor in a way that can be implemented by fiduciaries and their advisers. We should also mention that the checklist is designed for situations that we believe to be typical, but not every plan has the same considerations. Thus, the checklist may not fit the exact circumstances of any particular plan, and in assessing the suggestions in the checklist, fiduciaries need to examine the particular needs of their plan.

The checklist, which begins on page 18 of the White Paper, includes explanatory comments and descriptions of how the information can be obtained. The following summarizes some of the key points:

1. Review publicly available information about the strength and stability of the insurance company, including financial reports issued by the company and the company's risk based capital and capital ratio.
2. Review the company's Insurance Financial Strength ratings from the major rating agencies, with emphasis on consistent ratings over a period of years.
3. Seek out an insurance company with a well-known reputation in the annuity field, including a review of how long the company has been in business, its history of processing annuity payments, the company's reputation and the like.
4. Consider information related to state guarantee insurance for the product being considered. While insurance companies are limited in the information they may volunteer, they can provide information upon request. .

In the White Paper, we provide more details on what to look at and how to get the information.

Guaranteed income fulfills an important need for many participants in defined contribution plans. Plan fiduciaries have the task of selecting providers of that guarantee. The analysis and checklist in the White Paper helps fiduciaries and advisers do that job.