

SECURE Act: A dive into individual annuities in retirement plans

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As discussed in a previous article, the first of this series, the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 presents new and potentially vast opportunities for individual annuity carriers.

After a quick point of clarification, this article takes a deeper dive into the changes and provides some additional insights into the new law.

A Point of Clarification

As I have been discussing the changes implemented by SECURE, multiple other articles have referenced companies that are already offering annuities within their plans.

On the surface, it seems a bit contradictory to enact a law making it possible to do something that was already being done. This contradiction is borne by a misunderstanding of the types of products the articles (at least the ones I have read) are referring to.

Principally, they are not individual annuities in the traditional sense. They are typically funds offered within a plan, which are *not* individual annuities written by an insurance company, that have a guaranteed lifetime income feature attached to them that is underwritten/guaranteed by insurance companies. In many cases, the guarantee is supported by more than one insurance company. The key here is that it is an annuity-like income guarantee that is attached to a fund. *The fund, not an annuity, is the underlying investment.* The insurance companies just support the guarantees. For simplicity, I will call them “guaranteed income fund” products.

The products that are the topic of this article are individual annuity contracts in the traditional sense. I am discussing annuity contracts issued in whole, not just guaranteed, by an insurance company. The annuity itself is the investment.

Guaranteed income fund products do still expose the fiduciary to risk and liability associated with the financial capability of the insurance companies to support the guarantee, which is the same as required for a traditional individual annuity. They are similar in that sense. Having multiple insurers supporting the guarantees helped address this.

Guaranteed income fund products also did not solve the issue of portability. In fact, they come with their own additional set of portability-related issues beyond the tax-related issues that are alleviated by SECURE. For example, if a participant desires to roll out of the retirement plan under any of the allowable distribution circumstances (even the ones that existed prior to SECURE), the income guarantee is linked to a fund option that exists within the plan in which it was elected. While participants may be able to keep the investment if they are rolling it into another defined contribution (DC) retirement plan that also happens to offer the same fund option (which may be very unlikely), they may not otherwise be able to move the income guarantee out of the original plan in which it was elected. An individual annuity, however, while offered in the plan, is not linked to an investment that only exists within the plan. It can simply be moved out of the plan and remain a standalone individual annuity.

It is also important to understand that, as the guaranteed income fund products are linked to fund investments, they are fundamentally different as an investment from a fixed, structured, or indexed annuity. The comparable individual annuity contract is an individual variable annuity. Fixed, structured, and indexed annuities offer entirely different accumulation features than guaranteed income fund products.

One criticism of individual variable annuities as compared to the guaranteed income fund products is that they have higher fees. However, much of the fees are linked to the cost to distribute the annuity, which could very well be significantly lower when offered through a retirement plan. Additionally, a portion of the fees are often associated with a guaranteed death benefit. This is an attractive benefit not offered on the guaranteed income fund products. If this benefit is not desired for individual variable annuity products offered in retirement plans, the cost would go down for products that don't include them. Lastly, part of the cost of a variable annuity is associated with the investments available within the plan, which are often significantly less limited than a guaranteed income fund product.

Finally, because guaranteed income fund products are only guaranteed by insurance companies, they may be less attractive to participate in for insurers than offering their own annuities in a plan. Add to that the portability issues that remain with these guaranteed income fund products and it is unclear what place they may continue to have in a world where traditional individual annuities can be offered. Perhaps they do become the preferred fund investment versus variable annuities. It would seem unlikely that they would impact the opportunity for other types of individual annuities. As with many things, we will wait and see.

That all said, I move on to the topic at hand...

A Recap of the Changes

The changes made by SECURE that open up opportunities for individual annuity carriers relate to two primary topics:

1. **Fiduciary responsibility:** This relates to the responsibilities of the plan fiduciary for a tax-qualified DC retirement plan pertaining to the selection of an annuity carrier to offer an annuity as an investment option within the DC plan.
2. **Portability:** This relates to the ability of the participant to move the annuity if it is no longer an investment option allowable under the plan.

Fiduciary Changes

Previously, under ERISA, an annuity offered by a U.S. employer within a DC retirement plan subjected the plan fiduciary to the same duties and responsibilities as applied to any other investment option within the plan. Furthermore, ERISA states that a plan fiduciary that breaches fiduciary duties is personally liable for losses resulting from such a breach. In the case of an annuity, this includes the financial cost to the participant invested in that annuity if an insurance company was unable to pay the guaranteed benefit provided under the annuity contract.

It is not a difficult leap to understand why, when offering an annuity within a plan involved, the following factors created a climate ill-suited for fiduciaries to consider adding annuities as investment options:

1. Significant fiduciary responsibilities
2. Assuming personal liability
3. No incentive for fiduciaries

To address this, SECURE added a safe harbor for selecting insurers to offer annuities within the plan. The safe harbor clearly outlines the responsibilities of the fiduciary as it pertains to selecting an insurer. The general tenets of the safe harbor state that the fiduciary must:

1. Consider the financial capability of the insurer to satisfy its obligations under the contract.
2. Consider the cost of the contract in relation to the benefits and product features of it and the administrative services to be provided under such contract.

If the fiduciary concludes at the time of selection that the insurer is financially capable of satisfying its current and future obligations, and the relative cost of the annuity contract is reasonable, then they are in compliance.

Before you start asking yourself what that actually means, don't worry. SECURE goes into further detail about these two requirements. While lawmakers would be failing at their duties if they wrote a law that leaves nothing to interpretation, they did spell some things out.

FINANCIAL CAPABILITY OF THE INSURER

SECURE outlines what the fiduciary needs to do to satisfy tenet #1 above. The requirements generally involve obtaining written representations that amount to a background check on the insurance company. Key elements include the following:

1. The insurer is licensed to offer guaranteed retirement income contracts.
2. For each of the preceding 7 years the insurer:
 - a. Has operated under an active certificate of authority of its domiciliary state.
 - b. Has filed audited financial statements according to the laws of its domiciliary state under applicable statutory accounting principles.
 - c. Has maintained reserves that satisfy all statutory requirements of all states where the insurer does business.
 - d. Is not operating under an order of supervision, rehabilitation, or liquidation.
3. At least every 5 years the insurer undergoes a financial examination by the insurance commissioner of the domiciliary state.
4. The insurer will notify the fiduciary of any change in circumstances related to the above that would preclude the insurer from making such representations at the time of issuance of the guaranteed income contract.

If the above requirements are satisfied at the time of the issuance of the guaranteed income contract, and the fiduciary receives no notice of and is not in possession of evidence to the contrary, then they have satisfied their obligation to determine the financial capability of the insurer.

Representations must be reconfirmed annually, unless there is a change of circumstances during the year that would affect the insurer's ability to make such representations at the time the guaranteed income contract is issued.

Fundamentally, this all means that plan fiduciaries can rely on the statutory solvency frameworks when fulfilling their fiduciary duties. The requirements amount to qualitative due diligence, ensuring an insurer is adhering to the statutory requirements of their domiciliary state and the states in which they do business. Importantly, the fiduciary does not need to perform its own financial analysis of the insurer's financial capability to comply.

COST OF THE CONTRACT

SECURE also outlines very clearly that the fiduciary is not required to select the lowest-cost contract. The fiduciary may consider the value of the contract relative to the cost. The basis for assessing the value of the contract may consider the features and benefits provided under the contract. In addition to considering the contract itself, consideration may also be given to attributes of the insurer. Considering an insurer's financial strength is mentioned specifically.

While it is not explicitly stated, it would not seem to be a large leap to assume that this reasoning also applies to consideration given to accumulation rates and income payouts of the contracts that the plan fiduciary is assessing.

ONGOING FIDUCIARY DUTIES

While the above two items represent perhaps the two biggest additions contained within the safe harbor, clarification surrounding the ongoing responsibilities comes in a close third. SECURE outlines that, if the fiduciary complies with its other fiduciary responsibilities pertaining to the selection of the insurer and guaranteed income contract, then there is no requirement to review the appropriateness of a selection after the purchase of the contract.

LIMITED LIABILITY

Finally, SECURE addresses the key aspect of fiduciary liability. It explicitly states that a fiduciary in compliance with the requirements outlined in the safe harbor is not liable for any losses that may result from the insurer's inability to satisfy its obligations under the terms of the guaranteed income contract.

Portability Changes

"Portability" refers to the ability to move the annuity out of the DC retirement plan within which it was purchased. Prior to SECURE, there were two large impediments surrounding the portability of annuities purchased within a DC plan:

1. Qualified trust status
2. Allowable distributions

There are only certain circumstances under which investments within a retirement plan can be moved out of a plan without violating qualified trust status. Losing qualified trust status is effectively a taxable event. Similarly, there are only certain circumstances under which a participant can move money out of a retirement plan early. If one of the circumstances is not met, a 10% individual federal income tax early withdrawal penalty is assessed. Some examples of what are considered allowable distributions are severance of employment, disability, and plan termination.

It is sometimes the case that a plan fiduciary will remove an investment option from the plan. This can be for a variety of reasons, often to fulfill fiduciary responsibilities (e.g., an investment option is underperforming and/or a materially lower-cost alternative is available). Typically, an investment option can be substituted with a similar option that participants can use in its place.

However, if the plan fiduciary removes an annuity as an allowable investment option, it cannot easily be substituted. Many features of annuities are driven by when the contract was purchased. Income payouts, accumulation rates, fees, and many other features are often based on the purchase date and/or the time that has elapsed since purchase. Forcing a participant to liquidate the annuity to move it to a substitute can result in a significant loss of value for the participant. To avoid liquidation, the participant would have to move the annuity out of the plan.

As mentioned above, prior to SECURE there was no mechanism to do this without creating a taxable event and/or incurring an early withdrawal penalty. This was both a deterrent for employers to offer annuities as well as for participants to choose to invest in them if they were offered.

SECURE implements a few changes to address both issues.

QUALIFIED TRUST STATUS

To remedy the issue of losing qualified trust status, SECURE adds language to the section within the tax code that defines the rules of qualified trusts (section 401[a] of the Internal Revenue Code). The new language states that the annuity to be moved via a direct “trustee-to-trustee” transfer (I will refer to this as a “roll” or “rollover”), on or after 90 days prior to when the investment option is no longer authorized to be held as an investment option under the plan, may still be considered part of a qualified trust. In practice this means that if the plan no longer allows the annuity to be held as an investment option, then the annuity can be rolled out of the plan into another eligible qualified retirement plan (which includes individual annuities) within 90 days of that occurring without it being a taxable event.

ALLOWABLE DISTRIBUTIONS

While the language additions to the Internal Revenue Code (IRC) surrounding trust status alleviate the issue of a rollover being a taxable event, if the rollover occurred prior to the minimum retirement age defined in the tax code, then there would still be an individual federal income tax early withdrawal penalty assessed if none of the allowable distribution circumstances defined in the IRC are met.

These circumstances are listed in multiple sections of the IRC, with similar sections for 401(k), 403(b), and 457 plans.

SECURE adds language to these sections that aligns with the language added to the rules outlining qualified trusts. Within 90 days of an annuity no longer being authorized to be held as an investment option under the plan, the annuity can be rolled over into another eligible retirement plan without incurring an early withdrawal penalty.

The addition of this language to the qualified trust section and allowable distribution sections allows an annuity that is removed as an investment option within a retirement plan to be rolled out of the plan without creating a taxable event for any affected participant or incurring the early withdrawal penalty.

Much Left to Explore

There are still a lot of unknowns surrounding this new market and how all areas of an insurance company will operate within it. The questions are broad-reaching for a company wishing to enter this market and affect almost all areas of the company.

We at Milliman anticipate covering various aspects regarding the challenges, potential solutions, and opportunities of this market.

Topics include:

- The design and pricing of products for this market
- The potential operational challenges and solutions
- The potential impact on distribution and marketing

General updates are likely to come as deeper understanding of the regulation evolves.



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