Headwinds to annuities in 401(k) plans persist

Legal and administrative challenges have stalled uptake by plan sponsors

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The uptake of annuities in 401(k) plans has been muted and slow.

There are several reasons for this state of affairs, such as administrative and legal challenges, which have withstood the industry's push to change the status quo and many advisers' outlook on the perceived benefits of at least offering the insurance products to retirement savers.

"We're still at the margins," Philip Chao, principal and chief investment officer at advisory firm Chao & Co., said of the availability of 401(k) annuities.

This reticence by plan sponsors isn't for lack of trying. In 2014, the Treasury Department issued rules meant to promote the use of so-called longevity annuities in 401(k) plans, as part of a push for access to guaranteed income streams in the face of increasing longevity and declining access to pension plans.

That same year, the Treasury also approved the use of annuities in target-date funds in 401(k) plans, even when that fund is a plan's default investment option.

While plan sponsors have taken measures to improve retirement-income plan design in some ways — such as allowing savers to access their 401(k) accounts through regular withdrawals, rather than in one lump sum — annuity uptake remains stubbornly low.

According to a new survey published Wednesday by consulting firm Willis Towers Watson, 30% of 401(k) plan sponsors offer some sort of lifetime-income solution for participants. However, of those, the vast majority didn't use annuities: 88% offer systematic withdrawals and 70% offer education and planning tools, for example.

By comparison, only 17% offer funds (such as a TDF) with a built-in annuity component; just 15% offer a deferred annuity as a stand-alone investment option, and 15% connect participants to out-of-plan annuities using a third-party platform.

The use of lifetime-income options has increased by seven percentage points in the three years since the survey was last conducted. However, the overwhelming majority

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of that gain appears to be from noninsurance options, said Dana Hildebrandt, a consultant at Willis Towers Watson.

"It seems like people have adopted the low-lying fruit, and nothing in terms of meaty solutions," she said.

One of the big hang-ups seems to be a perceived legal barrier known as a safe harbor. Plan sponsors view the current safe harbor standard, which insulates them from legal risk, as difficult to satisfy, because it puts them on the hook for determining an insurer's solvency years down the road.

Legislation in Congress known as the SECURE Act would make this safe harbor more palatable for plan sponsors. After overwhelmingly passing in the House, the bill stalled in the Senate, although there are hopes that it may pass this fall by being attached to budget legislation.

"We're all waiting for the law to change and give us a safe harbor," Mr. Chao said. "Until then, nothing is going to change."

Target-date funds are a good example in this regard. TDFs are the most popular 401(k) plan investment, thanks in large part to safe-harbor regulations around so-called qualified default investment alternatives that the Labor Department issued in 2007, Mr. Chao said. TDFs held $1.7 trillion at the end of last year, according to Morningstar Inc.

The safe harbor wouldn't necessarily lead to a flood of uptake, however. Administrative challenges — such as the fact that not all record keepers can administer annuity products and participants can't really roll an annuity over to a new employer's 401(k) — are impediments, too. That's up to the industry to solve.

Administrative complexity and low demand from participants are the top two concerns about insurance-backed 401(k) products among plan sponsors, according to the Willis Towers Watson survey. Fiduciary risk — which would be addressed by a safe harbor — ranks third.

This is all despite observations by plan advisers that income options would benefit many participants. Mr. Chao, for example, believes annuities should at least be an option made available to participants.

Offering annuities would be a step up from plan sponsors' traditional plan design, which encourages participants to either roll money into a more-costly retail annuity option or leave money in the plan with limited distribution options.

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However, not everyone agrees annuities would necessarily improve the retirement-income situation.

John Scott, director of retirement savings at The Pew Charitable Trusts, pointed to low median account balances as an example. Participants 65 years and older had a median account balance of $58,000 at the end of 2018, according to Vanguard Group data.

That's not a lot of money to annuitize, Mr. Scott said, given other retirement expenses such as those for long-term care, health care and unexpected financial shocks.

It may make more sense for many participants to draw from 401(k) assets early in retirement and defer claiming Social Security as long as possible, Mr. Scott said, since doing so grants retirees 8% more in Social Security payments each year. Plus, since Social Security is a type of annuity, 401(k) participants may not need an additional annuity, he added.

"It's not quite as straightforward as it might appear," Mr. Scott said. "I think there has to be a little more thinking about the issue."

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