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Lifetime Income in Defined Contribution Plans: A Fiduciary Approach

A WHITE PAPER BY
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Executive Summary

Most Americans working today will not have the safety net of a guaranteed, lifetime benefit when they retire (other than Social Security). In the private sector, this is the result of the shift from defined benefit pension plans to defined contribution plans – primarily, 401(a) and 403(b) plans – as the predominant source of retirement income for most workers.[1] Even in the public sector, where employees traditionally have been covered by defined benefit retirement systems, there is significant pressure to reduce or eliminate these benefits and shift employees to defined contribution or deferral-based arrangements.

A material consequence of this shift to non-guaranteed defined contribution arrangements is that more and more workers will face significant risks in retirement. These include: a lack of understanding of the replacement income the retiree needs to preserve an adequate lifestyle; longevity risks, *i.e.*, the significant statistical probability that individuals will live longer in retirement than they expect; sequence-of-return risks, that is, the impact of investment market downturns at the "wrong" time; the lack of understanding about the appropriate rate at which retirement income can be withdrawn from a defined contribution account or IRA; inflation risk; and cognitive risk, *i.e.*, the loss of decision-making capacity as we age into our mid-80s and beyond.

Steps are beginning to be taken to address these risks. Providers of 401(a) and 403(b) plans are developing or enhancing products intended to be similar to defined benefit plan distributions. Government regulators are examining ways to change perceptions regarding the purpose of a savings plan from a platform for asset accumulation to a vehicle for income distribution.[2] As a part of this process, they are also looking at possible legal hurdles that may impede the adoption of lifetime income solutions. In addition, plan sponsors are beginning to assess how best to educate their participants and provide them with products that will help them obtain guaranteed lifetime income in retirement. (By "guaranteed lifetime income", we mean retirement income that is guaranteed by an insurance company to last a retiree for the remainder of his or her life or possibly for the joint lives of the retiree and his or her spouse.)

In this White Paper, we explore in detail the issues facing retirees, the alternatives being developed or that already exist to address retirement income adequacy and the legal issues that plan sponsors must consider in offering a lifetime income solution for their participants. (When we use the term "plan sponsor," we are generally referring to the responsible plan fiduciary of a retirement plan.) In particular, we focus on the fiduciary issue of selecting a lifetime income provider. This issue arises because payments to a retiree may not commence for a number of years and then may be made over a period of several decades. The fiduciary challenge is to select a provider today that will be there in the future to make

1 "Defined contribution plans dominate the retirement plan scene today." *LaRue v. DeWolff, Boberg & Associates*, 128 S.Ct. 1020, 1025 (2008).

2 *See*, for example, Rev. Rul. 2012-3, Rev. Rul. 2012-4, and proposed Treasury Regulation amendments regarding longevity annuity contracts.

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the payments, and the question is how a fiduciary acts prudently in making that selection.

The selection of a lifetime income provider is not inherently different from any other decision that must be made by plan fiduciaries, and it does not require a crystal ball. Every day, fiduciaries are required to make choices – about investments or service providers – with the certainty that only the future will determine whether or not the choice was appropriate. This is why the Employee Retirement Income Security Act of 1974 ("ERISA") and similar state laws focus more on the process fiduciaries use in making their decisions (*i.e.*, a prudent process) than on the outcome of their choices – the law does not require fiduciaries to guarantee the future, only to make prudent decisions based on the information available today.

While the Department of Labor ("DOL") has provided a safe harbor regulation under ERISA for the selection of annuity providers, it does not provide a true roadmap for fiduciaries to follow. (The DOL has indicated that the steps described in the regulation are not the exclusive means of engaging in a prudent selection process.) It appears, however, that if a fiduciary selects a well-regarded company from among the available candidates that others have chosen in the past – especially one that has a well-known reputation, a significant volume of annuity business and a history of managing that business, high ratings from the ratings agencies that are consistent across all the agencies and over a long period, and is well-financed – it is not necessary to engage in the exact steps described in the regulation.

In light of the focus on the process used by fiduciaries in making decisions and the importance of the lifetime income issue, in the remainder of this White Paper we discuss relevant legal principles related to the fiduciary decision and then examine the provider selection process. At the end of this White Paper, we offer a checklist of criteria that we believe constitute best practices in that process.

Importance of Lifetime Income

There are inherent inefficiencies associated with a retirement system premised on individual savings and investment decision-making. In the typical 401(a) or 403(b) plan, the individual participant must fund a major part of his or her own retirement, though plan sponsors often help through matching or profit sharing contributions. The participant generally needs to decide how much of his compensation to defer into the plan, how to invest it and, at retirement, how to take out the money. Because defined contribution plans have become the primary or the only retirement plan, they increasingly need to focus on lifetime income replacement rather than supplemental wealth accumulation. Many participants feel ill-equipped by education and experience to make these life-affecting financial decisions.

Indeed, studies have shown that most American workers are not saving enough to meet their retirement needs.[3] That problem is compounded by the fact that, on average, they are living longer and incurring higher healthcare costs, which means they need more money than they expect, and it needs to last longer than they expect.[4] As if that were not bad enough, as we age we become statistically more likely to suffer from dementia and other cognitive disorders and less able to make effective financial decisions.[5]

As a consequence, America is heading toward what some leading commentators refer to as a "post-retirement crisis," in which many will outlive their assets.[6] A number of factors are at the root of this problem, each of which by itself presents a serious risk but in combination can cause retirees to exhaust their savings far earlier than they anticipate. The following are the principal issues:

- *The replacement income issue*: This issue has several sub-parts. In our experience, most participants fail to translate their lump sum account balance in the 401(a) or 403(b) plan – which is often the largest accumulation of liquid funds that the employee will see in his lifetime and may be viewed as "wealth" rather than an income source – to an on-going stream of monthly payments. The second part of this issue is that participants do not recognize how much replacement income they will actually

3 *See*, for example, "Workforce Management and Retirement in a 401(k) World," Watson Wyatt Insider (September 11/ 2007).

4 *See*, Cantore, Tara, "MetLife Finds Too Many Pre-Retirees with Faulty Math," Plan Adviser (October 2011)

5 *See* Allianz of America, *Behavioral Finance and the Post-Retirement Crisis (A Response to the Department of the Treasury/ Department of Labor Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans)*, prepared by Prof. Shlomo Benartzi, UCLA, at page 9 (April 29, 2010) (the "Allianz RFI Response"); see also BMO Retirement Institute, *Financial decision-making: Who will mange your money when you can't?*, July 2011, which reached similar conclusions based on studies of the Canadian population.

6 *See* Allianz RFI Response, at page 4.

need. Studies suggest that the amount needed is between 75% and 85% of the participant's final pay in order to maintain the participant's standard of living in retirement.[7] These two factors then lead to the third part of the issue, which is the failure to understand how much participants must defer in order to achieve the kind of monthly income needed for retirement. Stated in simple terms, in our experience, most participants do not understand the extent of the problem or how to address it.

- *Longevity:* Statistics on life expectancy indicate that there is a 50% probability that, for a married couple aged 65, at least one spouse will be alive 25 years later and a 25% probability that one will be alive at least 30 years after retirement.[8] This means that, if the couple retires at age 65, to be reasonably assured that they will not outlive their funds, they need to plan on having replacement income for a period that is roughly 75% as long as their working years (*i.e.*, a "working lifetime" of 40 years and a retirement period of 30 years). We believe these facts are unknown to most participants and, therefore, are not considered in their retirement planning.
- *Sequence-of-return risks*: While not a new phenomenon, this issue has received increased attention in the last decade because of market downturns in both the early and late 2000s. The risk arises when a retiree takes withdrawals – which are necessary to provide the retiree with income – from a portfolio that is depreciating in value. The withdrawals have the effect of locking in losses caused by market downturns, which means that the amount of retirement savings is reduced and the ability to recoup the losses is diminished. This has a significant impact on how long retirement savings will last. If the investment return on a retiree's account balance is greater than the withdrawal rate, his savings will grow over time, even though he is withdrawing money from the account. But if the return is negative, even if the market later turns positive, the investment returns may not be enough to offset the losses resulting from the sale of investments when the market was down. Therefore, it is important for retirees to find investments that effectively eliminate the sequence-of-return risk.

  A related risk is what some call the "reinvestment risk." That is, if a fixed income product is held to maturity, it will need to be reinvested. This may occur at a time when yields are not high enough to produce adequate income. The effect would be similar to the sequence-of-return risk in that the retiree's income may be inadequate for the long term.
- *Withdrawal rate issue*: Studies have shown that a withdrawal rate of about 4%, inflation adjusted, has a 90% probability of lasting 30 years.[9] Yet few participants understand how much they can withdraw without running a significant risk of outliving their funds or even that they need to exercise considerable discipline in spending their accumulated savings "wealth." Indeed, when a defined contribution plan (and the lump sum account balance inherent in such plans) is the only retirement vehicle for most people, there is a risk that a retiree may take large withdrawals for discretionary purchases.

  The 4% withdrawal rate is much lower than most people think is possible; one recent study showed that more than 33% of those interviewed had no idea how much they could safely withdraw and roughly 25% expected to be able to withdraw more than 10% of their retirement savings each year.[10] (Higher withdrawal – or payment – rates are possible in some products, like annuities, where the rate may be as high as 7%, because of the pooling of longevity and investment risks by the insurance company.) The importance and widespread misunderstanding of this issue leads to the conclusion that participants need both education and assistance in selecting the vehicles that will handle the distribution or withdrawal process for them. (As discussed in the next section of this White Paper, certain products, such as annuities, provide for *payments* to the retiree rather than *withdrawals* from a pool of investments. For ease of reference, however, we use the term "withdrawal" to refer to both situations.)
- *Inflation risk:* As inflation erodes the spending power of a retiree's savings, he may need to withdraw more money to buy the same level of goods and services, which will mean that his funds are likely to run out sooner. Some

7 *See*, for example, Aon Consulting, "Aon Consulting/Georgia State 2008 University Replacement Ratio Study."

8 Reish, Fred, Ashton, Bruce and Byrnes, Pat, "The Problem with Living Too Long," Institutional Retirement Income Council (2010), http://www.iricouncil.org/docs/The%20Problem%20With%20Living%20Too%20Long.pdf.

9 William P. Bengen, "Determining Withdrawal Rates Using Historical Data," *Journal of Financial Planning*, October 1994, pages 171-180.

10 *See*, Lee Barney, "American All Over the Map on Retirement Drawdown Rates," Money Management Executive (October 13, 2011)

distribution arrangements, like Social Security and some government defined benefit pension plans, have inflation adjustment factors. There is, however, no built-in inflation protection in most private sector defined benefit, 401(a) or 403(b) plans or in rollover IRAs, other than the possibility that the investments in a participant's account may appreciate enough to offset inflation.

- *Cognitive risk*: Recent studies have shown that as people age, they experience some degree of mental deterioration that affects their ability to make sound decisions, such as those involving investments and distributions.[11] The diminution in capacity begins to be acute past age 80.

  Decisions about how to invest retirement savings for a 25 to 30 year time horizon, how to address inflation and market fluctuations, how and when to withdraw needed funds are complicated questions even under the best of circumstances. Thus, at or near retirement, participants and their spouses should decide whether to invest in products that reduce the need for them to make new investment and distribution decisions at a time when they are less capable of doing so.

In later sections of this White Paper, we discuss alternatives that are currently available for addressing the post-retirement crisis, the legal issues facing plan sponsors in trying to deal with these issues and suggestions for how best to address these legal responsibilities.

Addressing the Issue

Introduction

In this section, we examine two issues related to the lifetime income problem. The first is a description of the most common products available in the marketplace that address the issue. The second is whether these products should be offered within a retirement plan or as a distribution option or investment made available after funds have been distributed from a plan.

The key issues facing employers on whether to offer a lifetime income solution in their retirement plans are (1) the terms of the product or investment and (2) the ability of the issuer of the product or investment to fulfill those terms. Of these two factors, the second – the selection of the provider itself – may be the more significant. An analysis of these issues and suggestions for how to address them are contained in the next two sections of this White Paper.

Available Products

There are a number of insurance and investment products in the marketplace that are designed – or at least intended – to provide lifetime income. In this section, we discuss the most common ones. In the next section, we discuss the legal issues arising under ERISA and the Internal Revenue Code (the "Code") that may affect the products or investments.

For each product described below, we point out how well it addresses the retirement income risks described earlier. None of them is able to solve the benefit adequacy issue – that is, the accumulation of sufficient retirement savings to provide replacement income that is adequate to sustain a retiree's lifestyle – since that is largely a function of how much participants defer during their working years (plus what employers contribute in matching or non-elective contributions). In our experience, the solutions to the benefit adequacy issue may be best achieved through education and/or consultation with a retirement adviser or possibly through automatic enrollment and escalation of deferral rates (both of which are outside the scope of this White Paper).[12]

One final introductory note: we assume that all of the products discussed below are offered inside the 401(a) or 403(b) plan and that the participant's retirement savings are accumulated over time in the plan.

The products are the following:

1. *Traditional annuities*: Because they have been available for many decades and have been heavily marketed both in and outside retirement plans, traditional fixed annuities may be the most readily recognized and used of the products. The concept is straightforward: the participant deposits funds with an insurance company in exchange for the company's agreement to provide the participant with income for a specified period or for life. The insurance company then uses the deposited funds and its return on investments to pay the benefit, typically monthly, to

[11] *See*, David Laibson, "Cognitive Impairment: Precipitous Declines in Cognition Can Set the Stage for Poor Decisions About Retirement Finances," which appears in the Allianz RFI Response, http://www.dol.gov/ebsa/pdf/1210-AB33-617.pdf. Professor Laibson's research showed a significant decrease in "analytic cognitive functioning" as people age and that older adults make financial mistakes. In effect, older people are less able to make cogent financial decisions, to analyze financial data and properly consider risks, which suggests that they are less able to make sound decisions about their financial security once they reach their 80s…a point when they may live another 10 or more years.

[12] *See,* for example, VanDerHei, Jack and Copeland, Craig, "The EBRI Retirement Readiness Rating™: Retirement Income Preparation and Future Prospects", Employee Benefit Research Institute Issue Brief No. 344 (July 2010), at pages 6-9.

the participant. The insurance company that issues the annuity is essentially pooling the risk. That is, some annuitants will live to their life expectancy (as projected in actuarial tables), some will live longer and some will die earlier. For those that live to their life expectancy, the amounts deposited for the annuity plus investment returns will be adequate to make all required monthly payments. For those who live longer, the insurance company will have to use additional funds to make the guaranteed payments, but for those who die before their projected life expectancy, the amounts they paid will exceed the required payouts, thus providing an offset against the payments for those who live longer.

The principal advantage of annuity contracts for a participant is that they guarantee income payments for the life of the participant (and possibly his or her spouse) or for a guaranteed period selected by the participant and generally offer larger monthly payments than other types of products because they are being made out of both the principal deposited by the participant and the insurance company's return on investment. The principal disadvantage of annuities is that the participant relinquishes his retirement account (and access to its value during life) in return for the guaranteed payments. Further, once a contract is annuitized, there may be no residual cash value that can be passed on to the participant's heirs (other than his or her spouse in the case of a joint and survivor annuity) upon his death, unless he elects to annuitize for a specified period or the contract provides for a residual death benefit. (The experience of some insurance companies is that a majority of participants who annuitize their retirement savings elect a life annuity with a guarantee that payments will be made for a period of 10 years; in this way, they are able to assure that if they die before the end of the specified period, payments will continue to their beneficiary. Further, some participants may only annuitize a portion of their account, keeping a portion available for extraordinary expenses or for passing on to heirs.) Because of the lack of access to the funds and absence of any residual value, in our experience, many participants are reluctant to annuitize their retirement benefits.

In terms of the retiree risks described earlier, in a traditional fixed annuity the insurance company assumes the longevity risk, effectively eliminates the sequence-of-return and cognitive risks and solves the withdrawal rate question. The annuities issued by some insurers may also partially address the inflation risk by offering increased payments based on the return the insurance company is able to achieve on its investments or by possibly by tying the benefit payment to the performance of specific investments. The annuity also solves the second, critical issue of lifetime income, that is, the guarantee that income will be available for the life of the retiree (or for the specified period he has chosen) and possibly for the life of his or her spouse. Only an insurance company can legally offer this type of guarantee.

Because annuities often are backed by the full faith and credit of the insurance company (*i.e.*, the insurance company's general account), a critical issue for a plan sponsor in electing to offer annuities in its plan or as a distribution option from its plan is the creditworthiness and long-term ability of the insurance company to pay the benefits.

2. *Guaranteed minimum withdrawal benefit features*: Guaranteed minimum withdrawal benefit ("GMWB") features are ordinarily combined, or "hybrid," products that consist of a mutual fund (such as a balanced or target date fund) or similar investment vehicle and the GMWB feature, which is issued by an insurance company. Under a GMWB, in exchange for premium payments the insurer guarantees that it will pay the plan participant an annual percentage of his "benefit base" (which is usually the high water mark of his account balance) if the account balance runs out during the retiree's life. This guarantee is conditioned on the requirement that the retiree not withdraw more than a specified amount per year. If withdrawals begin at age 65, a common rate is 5% of the benefit base or 4.5% if the participant selects a joint and survivor guarantee; the withdrawal rates typically go to 6% and 5.5% if withdrawals start at age 70. Withdrawals in excess of the stipulated amount are permitted but will decrease the benefit base.

   One key difference between an annuity and a GMWB feature is that initially the retiree makes periodic withdrawals from his own investments until those funds are exhausted. Only at that point does the insurance company begin making payments. If the retiree's account balance is not exhausted during his lifetime (and that of his spouse if withdrawals are made on a joint and survivor basis), the insurance company will not be obligated to make any payments.

   The perceived advantages of a GMWB feature are that participants retain ownership of and access to their accounts, can continue to take advantage of investment appreciation while being protected from downside risk, and can pass any remaining cash value in the account to their heirs. At the same time, so long as the retiree observes the terms of the arrangement (such as the restriction on annual withdrawals), the account balance and the GMWB provide a guaranteed stream of retirement income payments. Generally, the guaranteed annual withdrawals after retirement will be less than those historically available under the traditional annuity (the difference being roughly 6-7% vs. 5%). A key reason for this difference is that, in the case of an annuity, the amount the participant deposits with the insurance company is far larger than the premium paid to the insurance carrier for the GMWB and a portion of the monthly payments are effectively a return of "principal."

The GMWB feature addresses the longevity risk, as well as the sequence-of-return risk and the withdrawal rate question. Two drawbacks to the GMWB feature, as compared with an annuity, are the smaller monthly payout amount (6-7% vs. 5% as noted earlier) and the fact that the GMWB requires that the retiree exercise constraint over withdrawals of funds, since the more that is withdrawn above the specified rate (*e.g.*, 5%), the lower the benefit base and the lower the guaranteed payment if and when it begins.

The inflation risk may be addressed indirectly through the investment returns on the account balance. In some GMWB products, the benefit base will continue to increase post-retirement as a result of positive investment returns, net of withdrawals, though the premiums for these products are also higher. Like an annuity, the GMWB feature also solves the lifetime income guarantee concern, but may leave the participant vulnerable to the cognitive risk issue, inasmuch as the retiree is responsible for taking his own withdrawals in accordance with the terms of the feature until his account is exhausted. Because the participant retains control over his investments until they are exhausted, if the retiree withdraws funds more quickly than the specified rate, the guaranteed payment amount also declines.

3. *Longevity insurance:* Longevity insurance is the name often applied to a type of annuity that is designed to start payments to the beneficiary when he reaches a specified age, often age 85.

   Longevity insurance is sometimes combined with other retirement income approaches to act as a "safety net" to address longevity risk and the risk that the retiree will spend down his retirement savings, but still need income at the point when the longevity insurance is activated, *e.g.*, at age 85. The obvious drawback to longevity insurance is that, as in any form of insurance, it only provides a benefit to a retiree if the covered risk occurs – in this case, if the retiree lives beyond the stated age. If he dies before reaching the specified age, the investment in the contract is lost, though the premium cost tends to be lower than other types of annuities for two reasons. First, the insurance company will be able to invest the funds it receives for a number of years before being required to make payments. Second, there is a statistical likelihood that at least some purchasers will die before reaching the age at which payments begin.

   These products address the longevity risk, in that they provide income starting at the point where a retiree may be running out of other retirement savings, and once the payments start, eliminate the sequence-of-return, cognitive and withdrawal rate risks. They also provide lifetime income once payments begin. They do not, however, typically address the inflation risk, so that a payment purchased today may have lost a significant amount of its purchasing power 15 or 20 years later. In addition, the risk factor of not living long enough to collect on the annuity can be a significant detriment to pursuing this alternative.

4. *Managed payout and retirement income mutual funds:* Managed payout funds are designed to provide a steady stream of retirement income while still allowing retirees access to their money during their lifetime and the ability to pass it onto their heirs upon death. Managed payout funds emphasize the decumulation phase – they make periodic distributions (often monthly) at a specified annual rate (3-7% of principal amount is the typical range). Nevertheless, because these are mutual funds and not insurance products, they cannot offer a guarantee that payments will continue for a specified period or the life of the retiree.

   There are essentially two types of managed payout funds, those that offer a defined term or payout period and those that offer a defined payout amount:

a. In the case of defined term funds, the fund establishes a set time period over which payments based on the invested principal and investment returns will be made. The payments are intended, but are not guaranteed, to keep pace with inflation and may fluctuate over time, depending on the gains or losses in the fund. As a result, retirees remain subject to the sequence-of-return risk and may not have enough to live on if losses deplete the fund too quickly. In addition, at the end of the defined term, periodic distributions will cease and the net asset value of the fund, if any, will be returned to the retiree. This could occur at a point when the retiree is especially vulnerable to the cognitive risk.

b. Defined payout funds are designed to provide for a specified payment percentage of the invested capital. Generally, the target distribution amount is set annually. The fund is designed (and managed by the fund manager) to make payments only out of earnings, though the fund manager has the discretion to pay out principal in order to meet the defined or target payout amount. These funds do not have a specified time horizon over which they will be paid. That is, the time period over which the payments will be made may be extended or shortened, depending on the investment gains or losses of the fund. As a result, retirees remain subject to the longevity and sequence-of-return risks.

Any fund's ability to meet its distribution objectives is dependent on the performance of the underlying investments, and even those that are designed to make distributions only out of earnings may be forced to deplete their investment principal if the investments under-perform the target.

While these types of funds operate in some respects like annuities, in that they are designed to provide monthly payments and a portion of the payment may be a return of principal, they are not guaranteed products and cannot promise a lifetime income stream. Unless the securities markets perform as well as anticipated during the payout period, these types of mutual funds do not solve the longevity, sequence-of-return, inflation or cognitive risks, and only the defined payout fund addresses the withdrawal rate risk (by providing for a specified payment each month) so long as the invested funds are not exhausted. This downside risk is offset to some degree by the fact that the funds tend to have a lower cost because there is no guarantee element built into the product.

5. *Managed retirement income accounts:* Unlike the annuities and managed payout funds, managed retirement income accounts are a service rather than a product. That is, a professional money manager undertakes to manage the account of the participant, often using the investment alternatives available in the 401(a) or 403(b) plan, with the investment objective being capital preservation and income. An added feature of the service is overseeing the monthly payout of benefits. Some of the services also suggest that the retiree purchase longevity insurance.

   An advantage of these services is that, while they are professionally managed, the participant nevertheless retains control over his account and can begin or cease payouts at any time and take additional withdrawals of funds if desired. This type of service offers monthly payouts, but like the managed payout mutual funds, they are not guaranteed, and do not solve the longevity, sequence-of-return, inflation or cognitive risks unless the securities markets perform well during the payout period (except to the extent the retiree purchases longevity insurance).

In-Plan *versus* Out-of-Plan Options

A key issue that needs to be addressed in the selection of a lifetime income product is whether to offer the product as an option in the plan (referred to as an "in-plan" solution), to offer it only as a distribution option (referred to as an "on-the-way-out-of-the-plan" or distribution solution) or to offer neither an in-plan or a distribution solution. If the latter alternative (referred to as the "out-of-plan" solution) is chosen, the participants are left to determine how best to deal with the lifetime income issue, though the plan sponsor may provide education for employees while they are participating in the plan to help them understand the retirement risks and potential solutions.

In this White Paper, we focus on the "in plan" solution, since it is likely to be the most advantageous to participants. That is, if the retirement income product or service is offered in the plan, the cost to participants may be substantially reduced because the plan can obtain pricing based on scale rather than the participant having to pay the "retail" cost of the product. Further, the "retail" cost of an out-of-plan product or service will vary depending on the account size, so that for participants with small accounts, it is significantly more expensive to obtain lifetime income protection outside the plan. With an in-plan solution, all participants can pay the same relative cost (for example, the same percentage of assets in their account), so that participants with smaller account balances pay the same relative cost as those with large account balances.

A perceived drawback to the "in plan" solution is that it imposes a fiduciary obligation on the part of the plan sponsor (or fiduciaries of the plan) to select and monitor both the product and the provider of the product. Even in the on-the-way-out-of-the-plan distribution solution (where the product is made available to participants who are taking a distribution of their account balances), this fiduciary concern exists because the plan sponsor must select the product that is made available to the participants, even though the participants must still determine whether the product is suitable for their needs and whether they are willing to bear the cost.

The only products that guarantee lifetime income are those issued by an insurance company. Where a plan offers such a product, the plan sponsor must engage in a prudent process to select and monitor the product itself and the provider of the product. In the next section of this White Paper, we will discuss the legal framework for this obligation and then offer some possible solutions for meeting the obligation.

Legal Framework

Applicable Law

In this section, we address the law that governs fiduciaries' selections of annuity providers and contracts to provide for distributions from individual account plans such as 401(a) and 403(b) plans. Our focus is on ERISA, DOL regulations under ERISA and court decisions interpreting ERISA and the regulations. ERISA governs retirement plans sponsored by private employers. Although ERISA generally does not apply to plans sponsored by governmental entities and churches – which are subject instead to state laws and general fiduciary concepts – many state laws closely track ERISA. At least 31 states have adopted laws derived from – and in some cases, verbatim to – ERISA's "prudent man" standard (which is discussed below).[13] Because the rules under ERISA (both regulatory and litigation-developed) are generally more well-defined than state law, the focus of our discussion centers on the ERISA rules, and throughout the remainder of this White Paper, we assume that ERISA – or state law similar to ERISA – governs the process by which fiduciaries select annuity providers for benefit distributions.

It should be noted that several states have some form of "any willing provider" laws on the books that would preclude governmental entities from limiting the number of providers that meet specified criteria from providing permissible investment products to their 403(b) plans. In those states, the fiduciary laws related to retirement systems generally may have little applicability to those 403(b) arrangements.[14]

[13] States that have incorporated language identical to or very similar to ERISA include Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Mississippi, Missouri, Montana, Nevada, New Hampshire, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Virginia and Washington.

[14] California Insurance Code §770.3. *See also* California Education Code §§25100-25115 for information regarding registration by vendors.

Before discussing the specific rules, it is important to note that the same principles that apply to the selection of investments and service providers generally apply to the selection of retirement income providers. Thus, while the specific facts that need to be considered in selecting such a provider may differ from other fiduciary decisions, the same standards and the same process apply; and fiduciaries should feel no greater discomfort in making that selection than they do in making any other fiduciary decision on behalf of the plan. Stated slightly differently, there is nothing unique about this selection process, and fiduciaries are not held to any different standard of care in making the decision.

ERISA'S "PRUDENT MAN RULE"

The process of selecting service providers for retirement plans is "... subject to ERISA's fiduciary oversight."[15] The fundamental obligations of ERISA fiduciaries are (1) to act "solely in the interest of the participants" and (2) "for the exclusive purpose" of providing benefits and defraying reasonable expenses of administering the plan. These duties, codified in Section 404(a) of ERISA, are known as the duty of loyalty and the exclusive purpose rules. Because of these rules, the officers, managers and directors who serve as plan fiduciaries have a duty of loyalty that runs directly to the participating employees and must act for the exclusive purpose of providing retirement benefits to the participants.

Fiduciaries are judged in accordance with the "prudent man rule" in carrying out their duties.[16] Specifically, a fiduciary is required to discharge his duties "with the care, skill, prudence, and diligence *under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters* would use in the context of an enterprise of a like character and

[15] *Mahoney v. J.J. Weiser & Co., Inc,* 564 F.Supp.2d 248, 256 (S.D.N.Y. 2008).

[16] ERISA §404(a)(1)(B).

with like aims …"[17] The standard is not the test of what an average person, or even a reasonable person, would do. Rather, as the prudent man rule says, it is measured by what would be done by a hypothetical prudent person who is "familiar with such matters."

The DOL has indicated that fiduciaries satisfy the prudent man standard if they give appropriate consideration to the facts and circumstances that they know or should know are relevant to the investment and act accordingly in making their decision.[18] The first part of the duty entails a proper investigation of the issues and results in the fiduciaries being properly informed.[19] That, in turn, enables fiduciaries to satisfy the second part of the duty, which is to make a prudent decision that is reasonably connected to the relevant information obtained through the investigation[20] – which we sometimes refer to as an "informed and reasoned decision."

The focus of the analysis of whether a fiduciary is acting prudently is less on the outcome and more on the fiduciary's conduct. That is, in evaluating whether a fiduciary acted in accordance with the prudent man rule, courts ask whether the fiduciaries "at the time they engaged in the challenged transaction, employed the appropriate methods to investigate the merits" of the transaction.[21]

The Selection of Annuity Providers

The fiduciaries responsible for selecting insurance companies for the purpose of providing annuities for in-plan investing or for benefit distributions must satisfy their fiduciary duties in doing so.

In 1995, the DOL issued Interpretive Bulletin 95-1 which provided guidance concerning ERISA's fiduciary standards applicable to selecting annuity providers for the purpose of making pension plan (*i.e.*, defined benefit plan) distributions. That Interpretive Bulletin provided that fiduciaries were required to take steps necessary to provide the safest annuity available, unless it would be in the participants' interest to do otherwise. In 2002, the DOL announced that these standards applied equally to fiduciaries of both defined benefit plans and defined contribution plans.[22]

In 2006, under Section 625 of the Pension Protection Act of 2006 ("PPA"), the DOL was directed to issue a regulation clarifying that the selection of an annuity contract as an optional form of distribution from an individual account plan, such as a 401(a) or 403(b) plan, is not subject to the "safest available annuity" standard of Interpretive Bulletin 95-1, but is subject to the otherwise applicable fiduciary standards.[23]

In 2007, the DOL issued a proposed regulation addressing the selection of annuity providers to distribute benefits under these types of plans.[24] The final regulation, effective December 8, 2008, "… establishes a safe harbor for satisfying the fiduciary duties under [the prudent man rule of ERISA] in selecting an annuity provider and contract for benefit distributions from an individual account plan."[25]

The regulation[26] is *not* the only means by which fiduciaries may satisfy their fiduciary obligations in selecting an annuity provider to provide benefits, nor did it establish the minimum standards. Rather, it sets out an optional means of satisfying this obligation.[27]

Because fiduciaries may satisfy their obligations other than by following the regulation, and because "safe harbors" ordinarily are viewed as creating a higher standard than the law requires, the regulation exceeds the "baseline" of what ERISA imposes on fiduciaries in meeting their obligations under the prudent man rule. In other words, rather than establishing a "standard of care" to which fiduciaries must adhere, the regulation provides a guide to fiduciary "best practices" in selecting an annuity provider and an annuity contract to provide benefits under an individual account plan.

The "safe harbor" is available to fiduciaries that engage in the following five steps[28]:

1. Engage in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities.

2. Appropriately consider information to assess the ability of the annuity provider to make all future payments under the annuity contract.

3. Appropriately consider the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract.

4. Appropriately conclude that, at the time of the selection, the annuity provider is financially able to

17 *Id.* Emphasis added.
18 29 C.F.R. §2550.404.a-1(b)(1).
19 *See, generally, Riley v. Murdock,* 890 F.Supp. 444, 458 (E.D.N.C. 1995).
20 *See, generally, Fink v. National Savings and Trust Company,* 772 F.2d 951, 962 (D.C. Cir. 1984).
21 *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir.1984); cert. denied sub nom, *Cody v. Donovan*, 469 U.S. 1072, 105 S.Ct. 565, 83 L.Ed.2d 506 (1984).
22 DOL Advisory Opinion 2002-14A (December 18, 2002).
23 *See,* 72 Fed.Reg. at 52021.
24 *Id.*
25 *Id.*
26 29 C.F.R. §2550.404a-4
27 29 C.F.R. §2550.404a-4(a)(2).
28 29 C.F.R. §2550.404a-4(b).

make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract.

5. If necessary, consult with an appropriate expert or experts in connection with their consideration and conclusions.

We discuss each of these in detail below, though we have combined the discussion of items two and four, since they are essentially two aspects of the same issue. At the end of this discussion, we summarize the process.

THE OBJECTIVE, THOROUGH AND ANALYTICAL SEARCH REQUIREMENT

This is an over-arching requirement of the safe harbor, described by the DOL in the preamble to the proposed regulation as "consistent with the requirements applicable to the selection of service providers generally."[29] While listed as a separate requirement, it appears to describe a basic structure within which the remaining requirements of the regulation fall, rather than establish an independent obligation.

It is important to recognize that prudence is determined at the time the decision is made and not measured using hindsight. Thus, if a fiduciary engages in an objective, thorough and analytical search and makes an informed, reasoned decision to select an insurance company to provide an immediate annuity, the fiduciary should not have any liability if the insurance company is later unable to make the promised payments. (Generally, there is an ongoing duty to monitor decisions to confirm whether an earlier decision remains prudent. In the case of an immediate annuity, however, the fiduciary has no on-going obligation.)

The "objective, thorough and analytical search" requirement is not new; the regulation essentially states the concept that has been required since the advent of ERISA for the prudent selection and monitoring of service providers and investments. For example, in Interpretive Bulletin 95-1, the DOL required fiduciaries to engage in an "objective, thorough and analytical search" for purposes of identifying annuity providers for distributions from pension plans. Similarly, in the preamble to the final rule related to qualified default investment alternatives ("QDIAs"), the DOL stated that "a fiduciary must engage in an objective, thorough, and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate."[30] The prudent man standard itself requires such an analysis even though different terms may be used in describing a fiduciary's obligations.

The preamble to the final safe harbor regulation points out that the process "must avoid self dealing, conflicts of interest or other improper influence, and should, to the extent feasible, involve consideration of competing annuity providers."[31] That standard – like the requirement that fiduciaries engage in an "objective, thorough and analytical search" – essentially restates the DOL's long-held view regarding the process required of fiduciaries in selecting service providers in general:

> "With regard to the prudent selection of service providers generally, the Department has indicated that a fiduciary should engage in an objective process that is designed to elicit information necessary to assess the provider's qualifications, quality of services offered and reasonableness of fees charged for the service. The process also must avoid self dealing, conflicts of interest or other improper influence."[32]

A good example of the analysis courts use to determine whether fiduciaries have engaged in an objective, thorough and analytical search can be found in *In re Unisys Savings Plan Litigation*,[33] a 1999 Court of Appeals decision. In *Unisys*, the plaintiff – a participant in the Unisys 401(k) plan – sued the plan fiduciaries responsible for purchasing three guaranteed investment contracts ("GICs") issued by Executive Life Insurance Company. The GICs were selected through three separate bid processes in 1987 and 1988. The Executive Life GICs constituted between 15 and 20% of the assets in the Unisys plan's "Fixed Investment Fund." Unisys delegated to two of its Investment Committee members the task of selecting investments for that Fund.

In connection with the first purchase, the committee members hired an experienced investment consultant who evaluated "many different insurance firms."[34] The consultant also obtained information and ratings from two major ratings organizations (Standard & Poor's and A.M. Best). The investment consultant testified that the ratings services were thorough because they analyzed raw data and interviewed

29 72 Fed. Reg.. at 52022

30 Preamble to ERISA Regulation §2550.404c-5, 72 Fed Reg. at 60453. *See, also*, Field Assistance Bulletin (FAB) No. 2007-01, Feb. 2, 2007, in which the DOL said, "With regard to the prudent selection of service providers generally, the Department has indicated that a fiduciary should engage in an objective process…."

31 73 Fed.Reg. at 58448.

32 FAB 2007-01.

33 173 F.3d. 145 (3rd Cir. 1999).

34 *In re Unisys Savings Plan Litigation*, 173 F.3d. at 151.

investment managers, and that he had a high degree of confidence in the ratings organizations.

Unisys reviewed the consultant's bid specifications, and the committee members knew the risks associated with some of the investments that Executive Life was making (such as high yield "junk bonds"). Further, Unisys presented evidence that, at the time the investment was made, GICs issued by carriers that invested in junk bonds were good risks.

The committee members also testified that they selected the Executive Life GICs because of their special features and to balance other investments in the Fixed Investment Fund. For example, the Executive Life GICs had longer maturity dates, their portfolios lacked real estate mortgages or derivatives and had a low proportion of commercial real estate investments. Moreover, the relatively high risk associated with the GICs' investments in high yield bonds was balanced with low risk, lower yield treasury bills.

The committee members decided not to use the consultant for the second and third bid processes, concluding that they – and other Unisys employees under their direction – had sufficient professional experience to select GIC issuers. In reaching their decision, they also considered the amount that the consultant had charged in connection with the first bid process. In the months between the bids, the committee members engaged in an ongoing process of reviewing and updating the information they received regarding the potential bidders, and kept abreast of developments in the GIC industry by reading trade publications and journals. They analyzed the portfolios and risks of the competing insurers using ratings information as sources of information about their assets and creditworthiness. (They testified that they would not have been able to replicate the ratings services' analyses.) They also consulted with a firm that had advised Unisys regarding its defined benefit pension plan.

On the basis of all of this information, the Court concluded that the Unisys fiduciaries had made a reasonable and thorough investigation of the Executive Life GICs, and agreed with the lower court's determination that "Unisys was prudent under the standard articulated in ERISA."[35] In other words, the process the fiduciaries used in connection with the second and third bids was prudent even though they did not engage a consultant to assist them.

As an alternative basis for finding in favor of the fiduciaries in Unisys II, the court held that, even if the fiduciaries had not performed a prudent investigation regarding the Executive Life GICs, a "hypothetical" prudent fiduciary also would have decided to invest plan assets in the GICs, and thus the Unisys fiduciaries should not be held to have violated ERISA. This concept may not have wide acceptance – the DOL would likely take the position that a failure to investigate is a per se violation of the prudent man standard regardless of the outcome.[36] And most observers take the position that under ERISA's prudence requirement, fiduciaries must evaluate the particular circumstances of their plans in making decisions. Nevertheless, fiduciaries faced with the decision of which annuity provider to chose may take comfort in the decisions reached by others.

For many decades, retirees have been receiving monthly payments from annuities. During those decades, insurance companies have been making those annuity payments, so the issue of selecting an annuity provider is not the product of a changing environment. It is impossible to know if all the fiduciaries of all the plans that have purchased these annuities engaged in a prudent selection process, much less an objective, thorough and analytical search. It is equally difficult, if not impossible, however, to conclude that a fiduciary that selected such an annuity engaged in a per se breach of his fiduciary duty. (One compelling factor regarding the strength of the insurance industry can be seen in the fact that, despite the deep recession in the last few years that saw the failure of many commercial banks and thrifts, investment banks, hedge funds and credit unions, not a single life insurer has had to be liquidated since the start of 2008.[37] While it is true that parent companies of several insurers received government bailouts, in general, the insurance company subsidiaries appear to have been insulated from the liabilities and imprudent business decisions of the parent or brother-sister entities.)

To illustrate the point slightly differently, assume that a fiduciary engages in a prudent process and reaches a prudent decision. Another fiduciary, who conducts no investigation, makes the same decision. Under the *Unisys II* court's alternative rationale, the second fiduciary would not be subjected to liability because the decision itself was inherently prudent.

ASSESSING THE ABILITY OF THE ANNUITY PROVIDER TO MAKE PAYMENTS

As noted, our analysis of this issue combines the requirement to appropriately consider sufficient

35 *In re Unisys Savings Plan Litigation,* 173 F.3d at 153.

36 For a contrary view, *see Fink v. National Savings & Trust Co.,* 772 F.2d 951, 962 (D.C. Cir. 1985).

37 Gallanis, Peter G., *NOLHGA, the Life and Health Insurance Guaranty System, and the Financial Crisis of 2008-2009,* June 5, 2009, at page 4.

information and to appropriately conclude that the annuity provider will be able to make all future payments. The final regulation does not specify what information fiduciaries should consider in making this assessment and reaching this conclusion, but the proposed regulation included a number of specific requirements that we believe are illustrative of the obligation and helpful in meeting these requirements. The proposed regulation indicated that fiduciaries should consider:

1. the annuity provider's experience and financial expertise in providing annuities of the type being selected or offered;[38]

2. the annuity provider's level of capital, surplus and reserves available to make payments under the annuity contract;[39]

3. the annuity provider's ratings by insurance ratings services (including consideration of whether an annuity provider's ratings demonstrate or raise questions regarding the provider's ability to make future payments under the annuity contract);[40]

4. the structure of the annuity contract and benefit guarantees provided, and the impact of using separate accounts to underwrite the provider's benefit obligations;[41]

5. the availability and extent of additional protection through state guaranty associations[42] and;

6. any other information that the fiduciary knows or should know would be relevant to its evaluation.[43]

The DOL omitted these factors in the final regulation on the grounds that, as part of the safe harbor, they were not necessary and were potentially confusing.[44] In the preamble to the final regulation, the DOL singles out two types of information mentioned in the proposed regulation, which suggests that consideration of that information may be viewed as a fiduciary "best practice." All of the factors listed in the proposed regulation are included here because they are instructive of the types of information the DOL apparently considered to be relevant, and they offer something of a guide to fiduciaries in assessing the ability of the annuity provider to make payments.

In the preamble to the final regulation, the DOL notes that "… although an annuity provider's ratings by insurance ratings services are not part of the final safe harbor, in many instances, fiduciaries may want to consider them, particularly if the ratings raise questions regarding the provider's ability to make future payments under the annuity contract."[45] In other words, the DOL considers insurance company ratings – in this case, ratings related to the carrier's claims paying ability – to be information that is important for fiduciaries to know. High ratings, especially if they are consistently high over a number of years and across the various rating agencies, would appear to be a strong indicator of an annuity provider's relative ability to make future payments under its contract. At the same time, if the ratings agencies provide any *negative* information about a prospective annuity provider, this should also be taken into account by the prudent fiduciary.

There are currently four major agencies that provide rating information for life insurance companies: A.M. Best, Fitch Ratings, Moody's Investor's Service and Standard & Poor's. Each agency establishes its own rating criteria and demarcation between sound and poor financial stability, although all are similar and all include a "financial strength rating" which represents "… an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations,"[46] *i.e.*, its ability to meet its annuity obligations. All of the agencies use letter grades to indicate the stability or riskiness of an insurer and to identify those companies that offer questionable or poor financial security. For example:

1. Best's Financial Strength Rating describes companies as either "Secure" (those rated B+ or better, with those rated A++ and A+ considered "superior") or "Vulnerable" (those rated B or below);

2. Fitch uses AAA and AA to designate companies with little or no expectation of ceased or interrupted payments; companies with lower ratings have some or considerable risk of ceased or interrupted payments;

3. Moody's identifies "high grade" companies with an Aaa or Aa rating, while those with an A or lower rating have some or considerable susceptibility to impairment;

4. Standard & Poor's uses AAA and AA for companies with extremely or very strong financial security characteristics, whereas those ranked A or lower have some or considerable likelihood of being affected by adverse business conditions.[47]

In reviewing ratings, it is important to recognize whether

38 72 Fed.Reg. 52025.
39 *Id.*
40 *Id.*
41 *Id.*
42 *Id.*
43 *Id.*
44 73 Fed.Reg. 58448.
45 *Id.*
46 *See*, http://www3.ambest.com/ratings/default.asp.
47 In August 2011, S&P lowered the credit rating of the United States from AAA to AA+ and as a result, similarly lowered the rating of all insurers with a AAA rating because the "U.S. sovereign credit rating constrains the long-term ratings on these U.S. insurers…"

the ratings apply to a parent company or to its insurance company subsidiary and whether the rating is a debt or credit rating versus an Insurance Financial Strength Rating. The latter would be more relevant to the inquiry regarding the ability of an insurer to meet its annuity obligations in future.

The rating agencies take into account, among other things, the "risk based capital" (or RBC) of insurance companies. The RBC system was developed by the National Association of Insurance Commissioners ("NAIC"), which is the standard-setting and regulatory support organization created and governed by insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight of insurance companies.

RBC was created to provide a capital adequacy standard related to risk that is uniform among the states. The formula used in determining an insurance company's RBC focuses on the material risks that are common for the various types of insurance companies and typically assigns a risk factor (or in some cases requires modeling) for each item. This is then used by the insurance regulators to establish a hypothetical minimum level of capital that the insurer is required to maintain under state law. An RBC ratio of less than 100% (that is, actual capital is less than the company's RBC) will trigger regulatory actions that become more severe as the ratio declines. These range from a requirement for the company to submit a plan to the regulators showing how it will correct its financial problems to a takeover of the company (if the RBC ratio falls below 35%).

While the RBC calculation of individual companies is confidential and not available to the public and was not designed to compare insurance companies, the rating agencies consider the "RBC ratio" of insurers as one factor in establishing their ratings, though there are other quantitative and qualitative factors taken into account. The RBC ratio is a measure of a company's required risk based capital compared to its actual capital; the higher the multiple of actual capital compared to RBC, generally the more highly regarded and the higher the rating of the company. For example, we understand that an insurer with a Moody's Aaa rating would be expected to have an RBC ratio of at least 400% (that is, its actual capital is four times its RBC).

The detailed rating agency report of an insurance company may not be readily available, though in our experience, many (but not all) companies will make the reports available on their websites or provide them upon request. Even if they do have access to the report, fiduciaries should consider whether they have the appropriate experience and expertise to meaningfully interpret the information. Investment advisers and insurance consultants, who are in the business of advising others on the strength of insurance companies, are likely to have access to a broader range of rating service information as well as the expertise to evaluate the information. These factors likely work in favor of (though by no means mandate) engaging a consultant in connection with the process of obtaining and reviewing rating agency information and reports and otherwise investigating the strength of competing annuity providers.

The second type of information omitted, but that, in the preamble to the final regulation, the DOL suggested fiduciaries may want to consider, is "some information regarding additional protections that might be available through a state guaranty association for an annuity provider … even if limited to that information which is generally available to the public and easily accessible through such associations, state insurance departments, or elsewhere."[48]

All states offer at least $100,000 in protection for withdrawal and cash values for annuities.[49] Information regarding the level of backing available through the various state guaranty associations is readily accessible via the internet.[50] All other things being equal, the greater the protection that may be available through a state guaranty association relative to a given provider, the better.

Not only must the fiduciary "consider" information regarding the annuity provider's ability to make all future payments under the annuity contract, and the costs of the annuity contract, it must also reach an informed and reasoned conclusion that – based on the information reviewed – the annuity provider is financially able to make all future payments and the cost of the contract is reasonable in relation to the benefits and services provided. This conclusion must be made "at the time of the selection" of the annuity provider. The regulation explains that the "time of selection" may be either:

1. The time that the annuity provider and contract are selected for distribution of benefits to a specific participant or beneficiary;[51] or

2. The time that the annuity provider is selected

48 *Id.*

49 *See,* http://www.nolhga.com/policyholderinfo/main.cfm/location/insolvencyprocess.

50 *See, e.g.,* http://www.nolhga.com/policyholderinfo/main.cfm/location/ga.

51 29 C.F.R. § 2550.404a-4(c)(1).

> to provide annuity contracts at future dates to participants or beneficiaries, provided that the selecting fiduciary periodically reviews the continuing appropriateness of its conclusion that the annuity provider is financially able to make all future payments.[52]

This means that the "time of selection" depends on whether the annuity is being issued currently or may be issued in the future. In the case of a participant receiving a distribution of his benefits in the form of annuity, the selection of the insurance company occurs at the point of distribution. Under the safe harbor regulation, there is no on-going obligation on the part of the fiduciary to monitor the decision because the individual is no longer a participant in the plan.[53] Conversely, there is an ongoing obligation to monitor the decision if the fiduciary is selecting an annuity provider currently that may not be called upon to issue annuities to participants or commence making payments under the annuities until a date in the future. (The latter would be the case where an annuity is a form of investment available under the plan – indeed, annuities are one of only two acceptable investments in a 403(b) plan – but payments to the participant or beneficiary do not commence until the participant takes a distribution from the plan.)

The DOL explained in the preamble to the regulation that the purpose of the alternative approach to the "time of the selection" of the annuity provider was to afford fiduciaries "flexibility concerning when they must meet the safe harbor conditions in order to take advantage of the safe harbor."[54]

In the case where annuities will not be issued or payments will not commence until a point in the future, in order to obtain the benefit of the safe harbor protection, fiduciaries should periodically review their decision, and evaluate and decide – using the same process and the same types of information that went into the original selection – whether the provider is still capable of making future payments and whether the cost of the contract continues to be reasonable in light of its features. There is no hard and fast rule regarding the frequency of any such periodic review. The DOL website, for example, recommends that "[a]n employer should establish and follow a formal review process *at reasonable intervals* to decide if it wants to continue using the current service providers or look for replacements."[55] The review should occur whenever new information comes to light that suggests there might be a problem with the selection; but in the absence of adverse information, a review annually or every other year should suffice.

52 29 C.F.R. § 2550.404a-4(c)(2).
53 *Id.*
54 73 Fed.Reg. 58448.
55 *See*, http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html. Emphasis added.

CONSIDERING THE COST IN RELATION TO THE BENEFITS

Regarding cost considerations, the final regulation differed from the proposed regulation only in the sense that it specifically added a reference to "fees and commissions" (as opposed to simply "the cost of the annuity contract"). The DOL explained that the addition was made "to emphasize [the importance of fees and commissions] to the fiduciary's decision making process."[56]

Although there may be no "fees" associated with an annuity contract, the relative "cost" of the annuity contract is presumably measured by determining the mortality assumptions and the interest rate applied by the providers under consideration and any commissions paid to a broker assisting in the process. The new service provider disclosure regulation under ERISA Section 408(b)(2) generally requires that brokerage commissions be disclosed by a service provider at the "point of sale,"[57] so this portion of the "fees and commissions" information should be made available without undue effort on the part of the fiduciary.

Two key factors that go into determining the monthly annuity payment that a participant will be able to purchase with the lump sum value of his plan account are the mortality assumption and the interest factor applied to the lump sum. In general, and all other factors being equal, the monthly benefit will be lower where the annuity uses a longer mortality assumption (*i.e.*, assumes the participant will live longer and thus require payments for a longer period of time) and/or a lower interest rate (i.e., the return on the investment of the lump sum amount by the insurance company will not yield as good a return) than a provider that applies a shorter mortality assumption and a higher interest rate. One factor that fiduciaries should consider in assessing the cost and monthly annuity payment amount is whether the insurance company offers an interest crediting rate that starts out at one level and then declines in later periods (*i.e.*, a so-called "teaser" rate).

In addition to pricing, fiduciaries also need to consider the contractual features of competing products – such as liquidity, surrender charges and the possibility of increases in annuity payouts after the commencement of benefits – because not all products are created alike. For example, a fiduciary might conclude that the benefit of a liquidity restriction coupled with a higher yield offsets a higher cost.

56 73 Fed.Reg. 58448.
57 ERISA Regulation §2550.408b-2.

While comparative pricing and other contract features are important, it is also important for fiduciaries to assess the financial strength of the carrier. Annuities issued by Executive Life were relatively lower priced than competing products, but in the long run, that company's financial weaknesses made the lower price a less significant factor in the selection process. Although the final regulation is silent about the specific steps a fiduciary might take in "appropriately considering" the cost of the annuity contract relative to the benefits and services provided, other DOL guidance may be helpful in framing the fiduciary's obligations.

First, the DOL consistently takes the position that the costs, fees and expenses associated with administering a plan should not be viewed in a vacuum. Rather, the reasonableness of charges to a plan for a product or service should be evaluated with reference to the particular arrangement. For example, in 2002, the DOL issued an advisory opinion that addressed the question of whether a fiduciary could – consistent with its obligations – enter into an agreement with a service provider that included certain indemnification or "hold harmless" language, or provisions that limit the extent of the service provider's liability. The DOL explained that entering into the agreement would not necessarily run afoul of the prudent man rule. Rather, the fiduciary was obligated to consider the reasonableness of the agreement – including cost -- in light of all the services to be provided, and that soliciting bids from several service providers is one means by which a fiduciary might obtain the relevant information:

> "With regard to the selection of service providers under ERISA, the Department has previously indicated that the responsible plan fiduciary must engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided. … What constitutes an appropriate method of selecting a service provider, however, will depend upon the particular facts and circumstances. Soliciting bids among service providers is a means by which a fiduciary can obtain the necessary information relevant to the decision-making process …"[58]

In other words, fiduciaries should not be viewed to have breached their duties simply because they do not select a "less expensive" annuity provider over a "more expensive" provider. As the DOL notes in its own website, "[f]ees are just one of several factors fiduciaries need to consider in deciding on service providers and plan investments."[59]

58 DOL Advisory Opinion 2002-08A (August 20, 2002).
59 http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html.

Thus, a fiduciary who selects an annuity that is more expensive may nonetheless be prudent in doing so. There may be a range of costs within which a fiduciary could be considered prudent regardless of the provider that is selected, all other things being equal. The issue is not whether the fiduciary selects the least expensive option but rather whether the fiduciary engages in a prudent, comparative process that takes into consideration, for example, the features of the products offered and the abilities of the competing providers to meet their future obligations (*i.e.*, the financial stability and security of the insurance company). Further, consultants may be able to help fiduciaries evaluate the costs of competing annuity products, and to evaluate those costs in relation to their potentially differing features.

CONSULTING WITH AN APPROPRIATE EXPERT

In this respect, the final regulation differs somewhat from the original proposal, which would have required the fiduciary to appropriately determine "… either that the fiduciary had, at the time of the selection, the appropriate expertise to evaluate the selection or that the advice of a qualified, independent expert was necessary."[60] Before assessing whether a fiduciary needs to reach out for assistance, it is important to understand the type of person or entity to which it can turn for that advice. While the DOL uses the term "expert," in other contexts, it has made clear that a fiduciary may rely on the assistance of knowledgeable consultants unless it has reason to "doubt the competence, integrity or responsibility" of the consultant.[61] In light of this, and the fact that it is difficult to determine who would qualify as an "expert" in this context, we use the term "consultant" in referring to the party to whom a fiduciary might turn for assistance in analyzing the prudence of an annuity provider selection.

The final regulation indicates that engaging a consultant is not required in all cases. Instead, it is up to the fiduciary to determine the extent to which it needs help in gathering and assessing the information needed to select the annuity provider.[62] However, other than to clarify that it is not required in all cases, the final regulation is vague with respect to whether – and to what extent – fiduciaries are required to engage consultants in connection with the selection of an annuity provider for distribution purposes. Other DOL guidance and case law shed light on when fiduciaries should engage consultants, what they should consider in hiring them and what they must do with the information they receive from them.[63]

60 72 Fed.Reg. 52024.
61 Interpretive Bulletin 75-8, Q&A D5.
62 *Id.*
63 *See, e.g.,* [cite]

Generally speaking, the law "does not impose a rule that fiduciaries be 'experts' on all types of investments they make. However, if a fiduciary lacks the education, experience, or skills to be able to conduct a reasonable, independent investigation and evaluation of the risks and other characteristics of the proposed investment, it must seek independent advice."[64] Consider, for example, the use of consultants by the plan committee in the *Unisys II* case discussed earlier. The size of the plan and the amount of its assets is relevant in deciding whether a fiduciary may need to consult with an expert in connection with the selection of an annuity provider. The DOL has recognized that, because the prudent man rule requires fiduciaries to conduct themselves in a way that a prudent person in "a like capacity" would do, fiduciaries of smaller plans may not be obligated to incur the expense of an expert consultant to the same extent as fiduciaries of larger plans. As the DOL stated in the preamble to its 1979 regulation relating to fiduciary investment duties:

> "Under the 'prudence' rule, the standard to which a fiduciary is held in the proper discharge of his investment duties is defined, in part, by what a prudent person acting in a like capacity and familiar with such matters would do. Thus, for example, it would not seem necessary for a fiduciary of a plan with assets of $50,000 to employ, in all respects, the same investment management techniques as would a fiduciary of a plan with assets of $50,000,000."[65]

Assuming the fiduciary concludes that advice is necessary, it must act prudently in selecting the consultant. As part of that process, the fiduciary must investigate the consultant's qualifications, ensure that it is independent, provide it with complete and accurate information and make certain that reliance on the consultant's advice is reasonably justified under the circumstances.[66] Many factors go into determining that reliance on the consultant's advice is justified, including its reputation and experience, the extensiveness and thoroughness of the consultant's investigation, whether its report is supported by relevant material, and whether the methods and assumptions are appropriate to the decision at hand.[67] This means, essentially, that fiduciaries may not simply "rubberstamp" a consultant's advice or recommendations, but must carefully review them and the reasons for them and make an informed and reasoned decision whether to follow the advice.

Courts have also stated that it is "extremely important" for fiduciaries to determine that the advice they are receiving from the consultant is *independent* and *impartial*.[68] Determining whether advice is independent and impartial depends in part on the consultant's motivations regarding the transaction. For example, fiduciaries should evaluate whether the consultant they have retained has a financial incentive to recommend one provider over another. When it appears that a consultant's advice may be motivated by its own financial interests, it calls into question the consultant's independence and impartiality in providing the advice. Fiduciaries, therefore, should proceed with caution in relying upon the consultant's advice.

Once they have hired a consultant to help them, however, fiduciaries may not blindly follow their advice. Instead, they must reach an independent conclusion regarding the merits of their course of action. "ERISA's duty to investigate requires fiduciaries to review the data a consultant gathers, to assess its significance and to supplement it where necessary."[69] Fiduciaries must make "independent inquiry into the merits of particular investments rather than … rely wholly on the advice of others."[70] Among other things, this means that the fiduciary must actually review the terms of the contract they enter into on behalf of a plan: "Fiduciaries need not become experts in employee benefits, and may rely on independent expert advice, but requiring that a fiduciary read the policy he signs and that he have a basic understanding of its most important provisions does not ask too much."[71]

SUMMARY

The selection of an annuity provider is not inherently different from any other decision that must be made by plan fiduciaries. While the ERISA safe harbor regulation does not provide a roadmap for fiduciaries to follow, it would appear that if a fiduciary selects a well-regarded company from among the available candidates that many others have chosen in the past – especially one that has a well-known reputation, a significant volume of annuity business and history of managing that business well, consistently high ratings from the major ratings agencies over a long period, and is well-financed – it is not necessary to follow exactly the same steps as described in the safe harbor regulation. Nevertheless, we believe that the criteria reflected in the checklist that follows would be appropriate in selecting a provider.

64 *Harley v. Minnesota Mining and Manufacturing Company,* 42 F.Supp.2d 898, 207 (D. Minn. 1999).

65 44 Fed.Reg. 37221, 37224.

66 *Howard v. Shay,* 100 F.3d 1484, 1489 (9th Cir. 1996).

67 *Bussian v. RJR Nabisco, Inc.,* 223 F.3d 286, 301 (5th Cir. 2000).

68 *Id.* at 303; *see also, Gregg v. Transportation Workers of America Intern.,* 343 F.3d 833, 841 (6th Cir. 2003).

69 *In re Unisys Sav. Plan Litig.,* 74 F.3d 420, 435-436 (3rd Cir. 1996); *see also, Bussian v. RJR Nabisco, Inc.* 223 F.3d 286, 301 (5th Cir. 2000).

70 *Gregg v. Transportation Workers of America Intern., supra,* 343 F.3d at 843, citing *Withers v. Teachers' Retirement Sys.,* 447 F.Supp. 1248, 1254 (S.D.N.Y. 1978), *aff'd mem.,* 595 F.2d 1210 (2nd Cir. 1979).

71 *Gregg, supra*, 343 F.3d at 843.

Sample Fiduciary Checklist

As indicated above, fiduciaries who are responsible for selecting annuity providers for the purpose of making benefit distributions are not obligated to follow the steps in the regulation in order to fulfill their duties. Assuming, however, that fiduciaries want to maximize the likelihood of identifying an annuity provider that is financially capable of making all annuity payments in the future, and to minimize the potential of personal liability, there are a number of steps that fiduciaries may consider taking as part of a prudent fiduciary process.

The first step in the process would be to identify the companies that could fulfill the plan's needs, *i.e.*, that offer the products that the plan is looking to provide to the participants. While this could be determined through an RFP process, the plan's financial adviser should also be able to identify likely candidates. The next step would be to perform the type of evaluation identified in the following checklist and to retain copies of the materials that are reviewed in due diligence files established for that purpose. For those fiduciaries who do not have the expertise (or perhaps the time) to conduct this type of review, they should consider engaging a consultant to assist them.

Although we describe these steps as part of a "checklist," there may be other factors not listed here that should be assessed, and the fiduciaries of each plan will need to consider the particular circumstances of the plan and its participants. Further, we do not mean to suggest that a fiduciary that fails to follow some of these steps – or even all of these steps – in selecting an annuity provider has breached his or her fiduciary duties. This checklist is not intended to define the fiduciary process for selecting an annuity provider but to provide a list of best practices that will assist fiduciaries in performing their duties. In this light, the checklist should be viewed as a tool that fiduciaries may consider using in helping them fulfill their duties and documenting that they have done so.

Strength and Stability. Review publicly available information about the insurance company, including

- financial reports (generally available on the insurer's website), paying special attention to the company's capital surplus and reserves;
- the company's RBC and RBC ratio (which should be available upon request);
- the actuarial opinion of the company's appointed actuary (which should also be available upon request); and
- the company's Insurance Financial Strength ratings from the major rating agencies (generally available on the insurer's website or upon request).

Comments:

The company's reserves measure whether the company has sufficient assets to meet its obligations. Surplus is the amount of assets in excess of reserves and other liabilities and available to cover unanticipated risks. The higher the surplus in proportion to the annuities on the books, the stronger the company's claims paying ability.

As discussed earlier, RBC is an insurance company's risk based capital, which is a measure of the company's capital adequacy. The RBC ratio measures the company's capital on a scale that factors in the riskiness of its assets and liabilities. An RBC ratio of less than 100% leads to required action by the company and/or the regulators, ranging from the company filing a plan to correct its financial problems to mandatory takeover of the company if the ratio is less than 35%. Ratios of 300% to 400% or higher generally suggest that the company is well-capitalized and may be highly regarded.

The actuarial opinion is filed by the company with state regulators and confirms whether the company has adequate funds available to pay for anticipated cash outflows over the projected life of outstanding annuities. The opinion should certify that the company's reserves are adequate to pay the anticipated cash flows and expenses under in-force annuities. Fiduciaries should verify that the opinion contains such a confirmation.[72]

[72] The actuarial opinion is accompanied by a memorandum that contains a detailed analysis and calculations that support the opinion. Because this memorandum contains confidential and proprietary information, it is not publicly available.

Ratings. The following information regarding the insurer's Insurance Financial Strength ratings should be reviewed (all of which should be available on the insurer's website or upon request to the company):

- the ratings over a period of years to determine whether they have been stable over time or have fluctuated during up and down economic cycles. Fluctuation may suggest financial instability. In addition, ratings on a comparative basis with other companies should be reviewed.
- the ratings given by the major ratings agencies should be reviewed to determine the consistency (or lack of consistency) among the agencies.
- to the extent possible, the report accompanying the ratings (which should be available on the company's website or upon request to the company) should be reviewed to determine whether there are adverse comments about the company that suggest vulnerability to future economic events.

Comment: As noted earlier, we understand that the highest ratings are given to companies with RBC ratios of 300% to 400%.

Fiduciaries should keep in mind that the major agencies use various letter grades to describe financially secure companies versus those that are vulnerable to adverse business conditions and, subject to the foregoing list of items, should presumably seek out companies with higher ratings. For example, Best's ratings of A++ and A+ are given to companies considered "superior" while those with a B or below rating are "vulnerable"; Fitch ratings of AAA and AA designate companies with little or no expectation of ceased or interrupted payments, while companies with lower ratings have some or considerable risk of ceased or interrupted payments; Moody's identifies "high grade" companies with an Aaa or Aa rating, while those with an A or lower rating have some or considerable susceptibility to impairment; and Standard & Poor's uses AAA and AA for companies with extremely or very strong financial security characteristics, whereas those ranked A or lower have some or considerable likelihood of being affected by adverse business conditions.

Track Record. Seek an insurance company with a well-known reputation in the annuity field. Much of the information to be reviewed should be available through an internet search and could include:

- how long the company has been in business;
- whether the company has a history of processing annuity payments and has a large volume of such business, including the dollar amounts paid out historically and annually, the number of annuities issued and the number of annuitants receiving benefits (all of which should be available from the insurance company upon request);
- information regarding the insurer's reputation and whether there has been material adverse information regarding the company in the news (which may be found through an internet search); and
- the company's regulatory history and any material litigation (which should be available upon request to the insurance company).

Costs. Consider the cost of the annuity, including:

- whether the company imposes sales charges, commission, surrender fees and other expenses that can reduce financial benefits to the participants. This information should be available in the description of the annuity product itself or upon request to the insurance company.

Transparency. Assess whether the information to be reviewed is clear and readily available. If not, this may suggest that there is adverse information that the insurer is reluctant to disclose.

State Guarantees. Consider the availability of state guarantee insurance in the states where the plan sponsor is located (and where most plan participants reside) and the extent of guarantee coverage for annuity contracts. This information should be available from the state insurance departments.

Conclusion

Participants in 401(a) and 403(b) plans face a number of risks in retirement because they must rely, to a large degree, on their own deferrals and investment decisions to accumulate retirement savings. Are they accumulating enough? How should they "spend" their nest egg? If they establish a spending plan, how much can they afford to take out each month? How long must the funds last and what happens if the markets go down at the wrong time or inflation begins to go up after they retire? Finally, how will they make sure they do not run out of money while they still need it?

Unfortunately, in our experience many participants appear to lack the education, experience and access to information needed to answer these questions. While ERISA and similar state fiduciary laws do not require plan sponsors or fiduciaries to provide the answers or a solution for the post-retirement crisis, we believe that better practice would be to provide assistance to the participants in dealing with the risks of retirement, including education and investment options that will address the risks.

Fortunately, the market place offers a number of solutions. One of the solutions – one that may most effectively address all of the risks – is the traditional annuity offered as an investment option or at least as a distribution option from the plan. Plan sponsors that elect to provide this solution are nonetheless faced with the issue of how to select the annuity contract and annuity provider. The DOL has provided some guidance in the form of the fiduciary safe harbor set out in the regulation outlining the process for selection of annuity providers for defined contribution plans. That guidance, coupled with a checklist of steps that a prudent fiduciary should consider taking – such as that set out above – and a robust participant education program should help fiduciaries in several ways: (1) to fulfill their desire to foster an understanding among their participants of the retirement risks; (2) to provide a solution for their participants to help avoid those risks; and (3) to fulfill their legal duty in selecting that solution.

The law and Drinker Biddle's analysis contained in this White Paper are general in nature and do not constitute a legal opinion or legal advice that may be relied on by third parties. Readers should consult their own legal counsel for information on how these issues apply to their individual circumstances. Further, the law and analysis in this White Paper are current as of May 2012. Changes may have occurred in the law since this paper was drafted. As a result, readers may want to consult with their legal advisers to determine if there have been any relevant developments since then.

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