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In-Plan Annuities: A Solution for Retirement Income Security?

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Although they haven't yet taken the retirement plan market by storm, so-called "in-plan annuities" are gaining acceptance among 401(k) plan sponsors. Annuities are insurance products that pay out income in the future and are popular for those who want a steady retirement income stream. Whether in-plan annuities can fit into your qualified retirement plan is a question you need to consider.

What Are The Numbers?

In 2014, LIMRA, a life insurance industry data-gathering organization, reported that total assets "covered by an in-plan guarantee" grew 31% during the previous two years, even though the actual dollars — about $3 billion — represent just a small fraction of the 401(k) asset universe. Also, while about 2.3 million plan participants have an in-plan annuity option available to them, the proportion who've used that opportunity is small. With this type of growth, in-plan annuities may become a fixture on the 401(k) landscape.

The trend is likely to be buttressed by IRS Notice 2014-66, published in October 2014, giving the agency's stamp of approval for in-plan annuities to be used as a component of a target date fund. That means they can become part of a qualified default investment alternative. With an annuity element automatically built into the investment lineup, many participants could wind up with an in-plan annuity absent an affirmative action on their part to reject it.

What Are The Choices?

In-plan guaranteed alternatives generally are one of three annuity formulas:

1. **Deferred fixed annuity.** This is the simplest choice. Plan participants purchase the annuity contract with their regular plan contributions. The formula calculates the guaranteed future income based on the interest rates and actuarial assumptions in place at the time of each contribution. The participant must begin taking the annuity at retirement. If he or she dies before the annuity is fully distributed, heirs may not recover any of the "wasted" contributions. By the same token, if the retiree lives to 100 years old, he or she comes out ahead of the game.
2. **Guaranteed minimum income benefit (GMIB).** To limit the risk that the interest rate and actuarial conditions will end up giving the retiree too little to live on, the annuity industry offers a GMIB. Under this option, the participant must annuitize the benefit at retirement. Regardless of the cumulative impact of low interest rate trends or life expectancy data, a GMIB guarantees the retiree a minimum benefit. And if investment performance of the underlying investment portfolio exceeds assumptions built into the original pricing model, the retiree can enjoy a higher benefit.
3. **Guaranteed minimum withdrawal benefit (GMWB).** As implied by its name, a total amount the retiree can take out has a fixed minimum, based on total contributions. The formula guarantees income amounts subject to a specified withdrawal rate, such as 5%. With a GMWB, participants maintain control over the account.

Some in-plan products, such as "systematic withdrawal plans," provide no guarantees. This option allows retired participants to determine the amount and frequency of their retirement income stream. Although not new, the model hasn't been popular, according to the Institutional Retirement Income Council (IRIC), possibly because of its variability of long-term security, depending on the periodic withdrawal amounts chosen by retirees.

Is It Time For An In-Plan Annuity?

One potential benefit of offering an in-plan annuity, according to IRIC, is reducing retirement plan expenses. This option may slow the number of rollovers, leading to more plan assets, which can give sponsors more leverage to negotiate favorable fee structures from plan service providers.

Fiduciary Responsibilities With In-Plan Annuities

As their name suggests, in-plan annuities can be part of 401(k) plans, thus coming under the fiduciary oversight obligations. Offering in-plan annuities requires more responsibility and perhaps complexity on the plan administrator's part, but represents a serious effort on the employer's part to safeguard a portion of retirees' income.

Alternatively, out-of-plan annuities are made available to plan participants only when they retire. In this scenario, the plan provides retirees access to an annuity shopping mechanism, not unlike a public health care insurance exchange, and the transaction is between the retiree and the insurance carrier issuing the annuity. The purchase of these annuities isn't a taxable event, as they're similar to an IRA rollover.

Here the plan sponsor is responsible for the administrative processes to facilitate the rollover transactions. According to a report by the Institutional Retirement Income Council (IRIC), out-of-plan annuities limit the employer's responsibility to ensuring that the annuity purchasing service provides retired participants with accurate information to navigate the process.