COMMENTARY

RETIREMENT

Are Annuities Expensive for Plan Participants?

For more than a decade, defined contribution (DC) plans have increasingly adopted features that directly or indirectly mimic their defined benefit (DB) pension counterparts, including automatic enrollment, automatic deferral escalation, and automatic investment selection and management. The implementation of these changes has benefited millions of workers who might otherwise not have saved, saved enough, or invested as effectively. By the time they reach retirement, their account balances will be larger. That's a great outcome. But then the question becomes: What do they do with those balances?

Unlike their DB counterparts, all of which offer benefits in the form of guaranteed lifetime income, most private-sector DC plans do not offer participants a means to convert account balances into annuity income. Over the years, at industry conferences, roundtable meetings, and in the media, we have heard many reasons for this apparent oversight: fiduciary concerns among plan sponsors, limited portability, complexity, and supposed lack of demand from participants. Yet it is the cost of annuities that is often singled out as especially troublesome — sponsors and participants should avoid annuity payouts because "annuities are expensive" due to high fees and surrender charges.

It's perplexing — and a bit irksome — to read this particular criticism. When referring to the "high cost" of annuities, critics appear to be conflating deferred individual annuities sold in retail markets (funded by rollovers from plans) with institutionally priced group annuities that are associated with retirement plans. In fact, there are multiple ways a retiree could receive annuity payouts from DC plans, most of which have no surrender charges or explicit "costs" at all:

- DC plans may have an arrangement — sometimes called "terminal funding" or "maturity funding" — whereby a group annuity contract is used to purchase lifetime annuity benefits for participants at the time they retire.

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- Plan sponsors could refer participants to a platform where they can view quoted prices for lifetime income payouts offered by different insurance companies; in theory, these quotes will be more competitive than those offered in the retail payout annuity market.
- Participants can use a portion of their funds to buy an income stream that starts later. This can be offered in a DC plan as a deferred income annuity or even as qualified lifetime annuity contract (QLAC) which can exclude those funds from RMD requirements.
- Some DC plans offer investment options that are deferred annuities, and these may indeed have costs higher than other investments within the plan. Yet these options also provide features other investments cannot — namely, guaranteed lifetime income payouts — making an apples-to-apples comparison flawed.

Some may argue that even payout annuities are still "expensive," despite not having any *explicit* costs, because they have *implicit* costs that will include a profit for the issuing company. But that would be true of any

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insurance-backed offering; and, in an open market, companies strive to make their products as competitive as possible.

Perhaps most important: Whether or not annuities are "expensive" depends on how much value the participant places on them. Based on our research, a sizeable proportion of individuals place tremendous value on guaranteed lifetime income; in some cases, people would opt for a lifetime income over a lump sum that far exceeds the actual cost.

The industry must work with media, educational organizations, advisory firms, and other institutions to counteract the tendency to define all types of annuities as "costly." Individual companies, alone or in partnership with their peers, should develop a common, straightforward approach to describing the pension-like value of annuity payouts, and how they provide a means to maximize income per dollar applied. With the "expensive" issue addressed, the industry can focus on the more important barriers to offering annuities, such as fiduciary concerns among sponsors. Regulatory changes may be necessary to clear the path. Once that happens, innovative companies will find ways to offer DC plan participants the means to enhance their retirement security — to create a lifetime pension from their DC plans.