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Plan Sponsor Considerations for In-Plan Annuity Offerings

Last year's newsletter included an article generally describing the initial compliance considerations when annuity options are added to a defined contribution plan. As predicted, we have seen a sharp increase in insurers actively reaching out to plan sponsors and retirement committees to present information on their annuity products. This article expands on last year's article to explain the safe harbor requirements for annuity offerings, which vary depending on the type of annuity selected and the manner in which it is offered.

Annuities in a Nutshell

Annuities vary in structure—fixed versus variable, immediate versus deferred, single life versus joint-and-survivor—but all annuities essentially provide guaranteed payments later in exchange for money today. Annuities offer tax benefits, certain value payments, and guaranteed rates of return but are also complex, relatively illiquid, and expensive. However, in-plan annuity options are usually less expensive than individually purchased annuities.

With **fixed annuities**, a *minimum* payout is guaranteed for the full distribution term when the first contribution is made, and an *actual* payout becomes guaranteed once distributions begin (immediate annuity) or the future distribution date is set (deferred annuity). The value of the payout is based on the account value used to purchase the annuity or the amount of premium collected plus a predetermined interest or crediting rate methodology.

In contrast, the payment streams in **variable annuities** are not guaranteed at the time of purchase because the crediting rate formulas used to calculate the payments are linked to an underlying investment with variable rates of return. Variable annuities can offer a **guaranteed lifetime withdrawal benefit** for a fee, which sets a guaranteed minimum payout at the time of purchase while still maintaining the potential upside from market returns.

Plan Sponsor Considerations

Retirement plan sponsors are not required to add any *particular* product, including an annuity, to a retirement plan menu, so the decision to offer (or not) an annuity product is subject to the general fiduciary duties in ERISA requiring fiduciaries to discharge their duties with loyalty and prudence, among other things. Additional fiduciary considerations arise that vary depending on the type of annuity offered and how it is offered.

Safe Harbor for Selection of Annuity Providers

When a plan fiduciary selects an insurer to offer a fixed-term or lifetime annuity, the fiduciary meets their duty of prudence if they:

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- Search objectively, thoroughly, and analytically to identify and select an annuity provider.
- Consider the financial capability of the annuity provider to satisfy its obligations under the annuity contract, which means obtaining certain written representations (e.g., the insurer is licensed to offer annuities, it has filed audited financial statements, it maintains sufficient reserves, it undergoes a financial examination at least once every five years).
- Weigh the costs of the annuity contract (e.g., fees, commissions, surrender penalties) against the benefits and services to be provided. There is no requirement to choose the lowest-cost annuity.
- Conclude that, at the time of the selection, the annuity provider is financially capable of satisfying its future payment obligations under the annuity contract and the relative cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract.

If, after considering these items, a plan fiduciary elects to add an annuity option to the plan's investment lineup, the fiduciary must also *monitor* the annuity provider through annual disclosures. If these conditions are met, the plan fiduciary is relieved of all liability for losses that may result from an insurer's inability to pay the promised annuity benefits.

Other Safe Harbors

ERISA Section 404(c)(1) provides a liability safe harbor for plan fiduciaries in participant-directed plans. To qualify for this safe harbor, the plan must, among other things, provide a participant or beneficiary an opportunity to exercise control and choose their investments from a broad range of investment options and provide sufficient disclosures to enable informed decisions. Section 404(c)(5) of ERISA also provides a safe harbor for a fiduciary that implements an appropriate Qualified Default Investment Alternative ("QDIA") in their participant-directed plans, such as a balanced fund, model portfolio, or target date fund, but can also include unallocated deferred annuity contracts as standalone fixed income investments or as a component of another investment product. As with other safe harbors, plan fiduciaries are relieved of liability for participant losses in QDIA investments, provided they meet certain disclosure and notice obligations and otherwise fulfill duties under ERISA.

Plan fiduciaries must therefore understand how the annuity component operates in the plan. For example, if the plan defaults its older participants into annuity contracts, the plan sponsor must evaluate the investment under both the annuity selection safe harbor and the QDIA regulation requirements. However, if the selected QDIA merely includes annuities as an embedded component of the overall investment holdings and the investment as a whole is managed by an investment manager (as described in Section 3(38) of ERISA) with discretion to select the component annuities, the fiduciary consideration is to prudently select and monitor the investment manager, which in turn will select and monitor the annuity provider in accordance with the annuity selection safe harbor conditions.

Finally, a plan with a self-directed brokerage window feature may permit participants to elect to allocate account assets to investments beyond those contained in the plan's investment menu, including individual securities, mutual funds, bonds, ETFs, options and annuities. The Department of Labor has provided little guidance to plan sponsors evaluating and selecting these arrangements apart from confirming that the same fiduciary duties of loyalty and prudence apply as when selecting other plan services. Thus, plan sponsors should consider their monitoring obligations if their brokerage advisors are recommending that participants roll over, transfer or distribute account assets from the plan to an outside annuity and understand how those obligations will be impacted by changes in the law (e.g., the changes to the Retirement Security Rule, which are currently on hold).

Plan fiduciaries who are considering adding or have annuity offerings must understand their initial and ongoing fiduciary and compliance duties, which will require expert investment, actuarial, and legal advice. If you have questions about annuities and how fiduciaries should conduct their review of available annuity products, please reach out to a member of our Employee Benefits and Executive Compensation group.