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When income is the outcome: Reducing regulatory obstacles to annuities in 401(k) plans

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Retirement Security Project at BROOKINGS

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers. Nearly half of all workers do not have access to an employer-sponsored retirement savings plan or a traditional pension. Among workers who do have access to such a plan, the shift from defined benefit pension plans to defined contribution plans makes it even more important for individuals to save for their own retirement. To address these trends, RSP proposes research-based policy solutions aimed at helping middle- and low-income Americans to better prepare for a financially

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DISCLOSURE

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ABSTRACT

Retirees with defined contribution plans face a key dilemma: how and when to convert their retirement savings into income in a way that minimizes the risk of outliving their assets without unnecessarily sacrificing their standard of living. Annuities offer one way to resolve this dilemma. We explore legislative and regulatory reforms that could encourage workers to annuitize more of their 401(k) and other defined contribution balances upon retirement. We propose changes that would create an appropriately protective fiduciary safe harbor for plan sponsors selecting annuity providers, increase the portability of annuities, and reform the required minimum distribution rules relating to retirement income.

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Introduction

From 1980 to 2010, the share of all workers participating in defined contribution (DC) plans, including retirement saving accounts such as 401(k)s, rose from 17 percent to 42 percent, while the share participating in a defined benefit (DB) pension plan fell from 39 percent to 14 percent.[1] Over the same period, participation and balances in Individual Retirement Accounts (IRAs) grew substantially.[2]

The shift from DB plans to retirement saving accounts like 401(k)s and IRAs creates different and increased risks and retirement planning tasks for workers. Unlike in DB plans, workers who participate in 401(k)s and IRAs are responsible for making choices during the accumulation stage—including whether to participate, how much to contribute, and how to allocate their balances across assets—as well as during the decumulation stage—choosing when and in what form to withdraw accumulated balances. The rise in automatic features has mitigated these concerns for many workers during accumulation, but not during decumulation.

Retirees face a key dilemma as they consume their retirement resources: how to manage the risk of outliving their savings without unnecessarily sacrificing their standard of living. Social Security and DB plans, which pay regular, guaranteed benefits for the lifetime of the worker (and often the worker's spouse), provide one solution. Commercial income annuities sold by insurance companies provide another key source of lifetime income. Even though income annuities appear to have significant potential to improve retirees' well-being, the market for such products has proven small to date.

In this paper, we explore legislative and regulatory changes that could encourage workers to annuitize more of their 401(k) and other DC plan retirement assets.[3] While not traditionally or frequently used to provide lifetime income, 401(k) and other DC plans have become a natural focal point for efforts to expand the use of annuities. Their advantages in providing income annuities include:

- economies of scale, including employer ability to wield bargaining power with insurers based on group purchasing potentially numerous annuity purchases;
- institutional pricing resulting from group purchasing and from direct purchasing from insurers, reducing customer acquisition costs largely by circumventing the labor-intensive, costly distribution channels that use agents, brokers, and advisors;
- the discipline imposed by plan sponsors' continuing fiduciary responsibilities to protect participants' interests when selecting/negotiating the type, terms, and price of contracts);
- the potential of earlier and group purchasing decisions to lower costs by reducing adverse selection across employees; and

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[1] Employee Benefit Research Institute (2012).

[2] Investment Company Institute (2018), U.S. Government Accountability Office (2017).

[3] A companion paper, John et al. (2019), explores ways to provide retirement income for DC plan participants that involve non-annuity vehicles.

- enhanced access, facilitated by the workplace, payroll system, and plan structure, to behaviorally effective strategies for overcoming participants' inhibitions about annuities.[4]

We propose policy reforms that would create an appropriately protective fiduciary safe harbor for plan selection of annuity providers, increase the portability of annuities offered in plans, and reform the required minimum distribution (RMD) rules relating to retirement income.

Section I provides background information on annuities. Sections II, III, and IV outline the three areas for reform and our proposals. Section V concludes.[5]

I. Background

A. Definitions

A life annuity is a financial product or contract (a) offered by an insurance company and issued to an owner, in which (b) the owner makes one or more payments to the company (like insurance premiums) and (c) at a specified later date, the company initiates regular (typically, monthly) payments to the owner that last for the duration of the owner's life.[6]

Annuities vary in many ways around this basic structure. Payments to the owner can begin soon after the annuity is purchased (an "immediate annuity" or "single premium immediate annuity") or years later (a "deferred annuity" or "deferred income annuity"). "Longevity annuity" sometimes refers to any deferred annuity but often refers specifically to a deferred annuity that begins payment only on attainment of an advanced age such as 80 or 85.[7]

Fixed income annuities typically provide regular payments (usually monthly) that are guaranteed to be a set nominal amount and that either continue for a specified number of years (a fixed term or installment distribution) or are guaranteed to last for the lifetime of the owner (and, often, a spouse or other designated beneficiary). An annuity that is "principal protected" or provides a "return of premium" death benefit pays the designated ben-

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[4] These strategies include choice architecture using default options, framing the annuity purchase decision in terms of guarantees, risk-shifting insurance, and consumption rather than in investment terms that emphasize return on investment, and other techniques to encourage take-up; employer-provided financial education and expert counseling; incremental participant decision making; gradual acquisition of deferred annuities that includes dollar-cost-averaging of interest rate risk; group arrangements with annuity quotation and purchase platforms, and other plan- or workplace-based approaches.

[5] The Appendix provides further discussion of fiduciary safe harbor issues.

[6] "Life annuities" are also sometimes called "income annuities" to distinguish them from "deferred fixed annuities," which provide a fixed, guaranteed rate of return for a specified period of years, and from other annuity contracts that are generally designed as tax-favored investment vehicles with accumulation features that could, but usually are not expected to, pay a stream of income.

[7] To help encourage DC plans and IRAs to provide lifetime income, the U.S. Treasury Department and IRS in 2014 authorized "qualifying longevity annuity contracts" (QLACs). QLACs are longevity income annuities for DC plans and IRAs that may begin payments as late as age 85 and that are subject to other conditions designed to promote simplicity and transparency and to facilitate product and price comparisons (U.S. Department of the Treasury 2014; Internal Revenue Service 2014b).

eficiary the remaining value of annuity principal if the annuity purchaser dies before receiving it in the form of annuity payments. Some annuities offer partial or full protection against inflation.

Fixed income annuities, promising to convert a sum of money into a predictable income stream for life, tend to be relatively straightforward. Insurers back up the promised payouts by maintaining capital reserves largely invested in bonds (and other assets) of appropriate quality and duration pursuant to state regulatory requirements. In addition, insurers can manage their longevity risk by pooling customers with a range of life spans (premiums from those dying earlier subsidizing continued payments for those living longer), and by hedging the longevity risk insurers assume when issuing annuities with their mortality risk from selling life insurance.

Insurers also compete with market-based investment products outside the insurance industry using annuities designed as tax-favored investment products, such as variable annuities. These provide payments that vary depending on the performance of the product's underlying investments (essentially mutual funds, equity-indexed investments, and the like) and therefore entail higher risk and potentially higher returns.[8] This increasing emphasis on asset accumulation departs from annuities' original and distinctive role: protecting against longevity risk by pooling mortality credits and providing guaranteed lifetime income in retirement.

However, the variable annuities are often sold together with a "guaranteed lifetime withdrawal benefit" rider that provides a form of longevity risk protection by guaranteeing a specified lifetime benefit under certain circumstances.

The fastest growing investment-oriented annuity type is the equity indexed or fixed indexed annuity. Indexed annuities are hybrids combining elements of variable and fixed income annuities, offering guaranteed minimum returns while also allowing higher returns linked to a market index (such as the S&P 500).[9]

Accumulation products such as indexed and variable annuities also tend to be more complex and opaque because they pursue a variety of objectives: for the consumer, the upside potential for tax-deferred investment growth, often combined with some form of guarantee against losses; for annuity providers and distributors, higher profit margins, commissions, and fees, with the ability to compete against mutual funds and brokerage firms. As a result, consumers purchasing (tax-deferred) variable annuities within a tax-qualified plan or IRA also may be paying for redundant tax advantages. In addition, when offering investment growth with guarantees against market risk, it can become harder for insurers to hedge their risks because market risk, unlike longevity risk, is not managed through diversification of insured life spans or hedged through life insurance in which insurers take on countervailing mortality risk.

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[8]Unless these annuities are included in tax-qualified plans, they are not subject to nondiscrimination standards, maximum limits, or most other rules that apply to tax-qualified plans.

[9] Numerous other indexes have been developed for these products in recent years, raising concerns about performance illustrations used in marketing to investors. The Financial Industry Regulatory Authority (FINRA) has said that indexed annuities are complex and that investors will find it difficult to compare one indexed annuity with another.

B. The Benefits of Lifetime Annuities

Economic theory shows that life annuities can increase individual welfare by balancing the risk associated with lifespan uncertainty and the risk associated with unnecessary reduction in living standards. Under certain conditions, risk-averse individuals with uncertain lifespans will choose to annuitize all their wealth. These conditions are restrictive and include the presence of complete markets, the availability of actuarially fair annuities (with zero transaction costs), and the absence of bequest motives.[10]

But even in more realistic models, individuals are still predicted to have welfare gains from partial annuitization of their wealth.[11] Mitchell et al. (1999) find that in a simplified stochastic life-cycle model, without bequest motives, individuals would prefer certain annuities to an optimal consumption strategy without annuities. Horneff et al. (2006) find that the optimal age to purchase an annuity varies, with younger individuals and those with lower levels of risk aversion choosing to keep assets out of annuities, but older individuals and those with high risk aversion deriving benefit from annuitization.

C. The Market for Income Annuities

Despite the theoretical advantages of annuities, the market for private annuities in the United States appears to be small relative to total retirement assets. As of the last quarter of 2018, U.S. retirement assets amounted to $27.1 trillion, of which $2.1 trillion was held in annuity reserves.[12] As a share of total retirement assets, annuity reserves have remained relatively constant—ranging between roughly 8 percent and 10 percent—since the mid-1980s.

These figures, however, overstate the amount of retirement-income-related annuity assets because much of the “annuity” market consists of products that are not expected to provide a stream of guaranteed lifetime income. Instead, as noted, these products—variable, indexed, etc. —are designed to function as equity-based investment products with accumulation features that benefit from the tax-deferred treatment originally intended for life insurance or life annuities. At the beginning of 2018, $453.7 billion was held in fixed annuity assets, consisting of 15 percent of the total assets held by forms of deferred annuities or less than 2 percent of all retirement assets.[13]

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[10] Yaari (1965).

[11] See, e.g., Davidoff, Brown, and Diamond (2005).

[12] Investment Company Institute (2019).

[13] LIMRA (2018).

D. Why is the Income Annuity Market So Small?

Why the retirement income annuity market is not larger, even though it seems as if many individuals could benefit from additional annuitization, is a key question (sometimes referred to in the literature as the "annuity puzzle") for policymakers and researchers.[14]

In fact, numerous factors limit annuity participation.[15] First, Americans already own annuitized wealth through Social Security and (effectively) Medicare. Many may view these programs as sufficient security against the risk of outliving assets, and thus prefer to keep the rest of their wealth in more liquid and flexible forms, to be used to fund uncertain health care expenses, bequests, etc.[16] Second, for some retirees, traditional risk sharing within families can further reduce the need to buy a commercial annuity.[17] Third, annuities are often expensive (or are perceived as such) relative to actuarially fair instruments. Adverse selection, high fees, and other issues drive up costs.[18] Fourth, income annuities generally need to be illiquid to limit adverse selection and to support the guaranteed income level. Purchasers generally are contractually locked in to annuity contracts once income begins and face substantial surrender charges if they exit earlier. Fifth, the many financial advisors who charge clients a percentage of the assets they manage have a financial incentive to avoid recommending investments (such as annuities) that reduce their assets under management. Sixth, for some years now, interest rates have been low by historical standards, while stock market returns over the past decade have been high. Low interest rates reduce the income that investors can obtain from an annuity purchase of a given size.[19]

Behavioral research has identified additional factors that plausibly limit consumers' interest in annuities. Many feel uncomfortable spending a large sum to purchase what appears in comparison to be small monthly payments or have little experience trading off resources over long periods of time. Thus, even when offered an actuarially fair annuity, they may prefer a lump-sum payment.[20] Another common concern is financial loss in the event of death soon after purchasing the annuity ("What if I get hit by a bus tomorrow?"). This concern may be allayed by joint and survivor annuities or a lump-sum "return of premium" death benefit. More fundamentally, however, this worry reflects the view of annuities as a gamble, rather than as insurance against outliving one's resources—in essence, the

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[14] Benartzi, Previtero, and Thaler (2011) provide a particularly thoughtful discussion, including data suggesting that significant numbers of DB plan participants choose lifetime income streams even when offered a lump sum alternative.

[15] See Beshears et al. (2018), Abraham and Harris (2015), and Brown (2007) for an overview.

[16] See Dushi and Webb (2004), Lockwood (2012).

[17] Brown and Poterba (2000). Reichling and Smetters (2015) show, building off of the Yaari (1965) model, that when mortality risk is correlated with shocks to health care status and hence health care spending, demand for annuities falls significantly.

[18] When consumers have private information about their health, insurance companies can expect that individuals with longer life expectancies will be more likely to buy annuities while those with shorter life expectancies will stay out of the market. This creates a pool of annuity purchasers that lives longer than average and hence raises the costs of providing annuities. High fees also drive up the costs of annuities (Brown 2007).

[19] Brown, Poterba, and Richardson (2017).

[20] Brown, Casey, and Mitchell (2007). The tendency to undervalue the income equivalent of an account balance, for example, is sometimes characterized as "wealth illusion".

perception that if the purchaser died too soon after purchasing the annuity, the annuity would be lost and wasted.[21]

Negative press coverage, reputational issues, and related factors have also affected consumers' perceptions and demand. Indexed and variable annuities and related products have often been criticized on the ground that some of these products present a confusing array of nonstandard features, terminology, and branding, with high fees, commissions, and surrender charges. Complexity and lack of transparency can raise costs to consumers by impeding price and product comparisons, dampening competition, and possibly depressing even the sales of simpler, lower-margin products such as fixed income annuities.[22] Also, annuity providers often retain the ability to unilaterally modify contract terms years after the customer entered into and paid for the contract. This presumably reduces consumers' trust of annuities and those who sell them, especially because of press reports that insurers have resisted disclosure to prospective customers (or the public) of their past pattern of unilateral modifications to similar contracts.

The distribution of annuities by insurance agents, brokers, "insurance marketing organizations," and other intermediaries has also been widely criticized on the ground that conflicts of interest, complexity, and lack of transparency—as well as legislation blocking the Securities and Exchange Commission's (SEC) efforts to regulate indexed annuities[23]—reportedly have protected and promoted higher commissions, fees, and other charges.[24]

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[21] Brown, Kling, Mullainathan, and Wrobel (2013) find that life annuities are more attractive when presented in a way that emphasizes what the annuity will finance than when presented in a way that highlights the wealth accumulation aspects of annuities. With the investment frame, many people, if willing to purchase an annuity at all, prefer products that offer a principal guarantee (such as the return of unrecovered premium upon death), ensuring that they cannot "lose" their investment. Consumers' tendency to bring an investment rather than an insurance or consumption frame to the purchase decision may be promoted by the industry's pursuit of investment products. In addition, savers' perceptions may be shaped importantly by institutional culture, including longstanding institutional framing, traditions, or norms. These factors might help explain, for example, why, despite the popularity of lump sums in the many DB plans that offer them, many other DB plans have continued to offer only annuities and not lump sums, as well as why annuity take-up among traditional TIAA-CREF customers has historically been higher than among other groups.

[22] A FINRA "Investor Alert" (2010) included the following: "Why an Alert on Equity-Indexed Annuities? Sales of equity-indexed annuities (EIAs)—also known as "fixed-indexed insurance products" and "indexed annuities"— have grown considerably in recent years. . . . EIAs are anything but easy to understand. One of the most confusing features of an EIA is the method used to calculate the gain in the index to which the annuity is linked. To make matters worse, there is not one, but several different indexing methods. Because of the variety and complexity of the methods used to credit interest, investors will find it difficult to compare one EIA to another." Because of concerns such as these, one type of fixed income annuity— the QLAC—is subject to federal regulatory conditions intended to ensure simplicity of product design and promote product and price comparison. Internal Revenue Service (2014b).

According to another FINRA "Investor Alert" (2012), "The marketing efforts used by some variable annuity sellers deserve scrutiny— especially when seniors are the targeted investors. Sales pitches for these products might attempt to scare or confuse investors. . . . Many such claims are not based on facts, but nevertheless help land a sale. While variable annuities can be appropriate as an investment under the right circumstances, as an investor, you should be aware of their restrictive features, understand that substantial taxes and charges may apply if you withdraw your money early, and guard against fear-inducing sales tactics."

[23] Section 989J of the Dodd-Frank legislation (known as the "Harkin amendment") prohibits SEC regulation of indexed annuities (the fastest growing type) by treating them as not being securities.

[24] Most annuities are typically sold in a labor-intensive fashion through networks of "producers" generally working on commission rather than on a flat-fee basis. These competing agents, brokers, wire houses, financial advisors, insurance marketing organizations, and other intermediaries vary widely in their training and standards, and many have been taken to task for their indexed and variable annuity sales practices and sales incentives. See, e.g., Office of Senator Elizabeth Warren (2015). While the Department of Labor's (DoL) short-lived fiduciary rule had apparently begun to help curb some of the widely-reported conflicts and excessive fees and commissions for indexed and variable annuities, its removal in 2018 may have prompted at least a partial relapse.

Problematic product designs and sales practices for some types of annuity products should not obscure the fact that straightforward and competitively priced commercial income annuities can play an important, pro-consumer role in retirement planning, especially as one portion of a broader portfolio.[25] Moreover, in our view, variable and indexed annuities also are not inherently problematic; appropriately designed, regulated, and sold, competitively priced, and free of the troubling issues that have arisen too often in the market, some of those products too can be consumer-protective and help savers convert their balances into valuable retirement income with longevity risk protection.[26]

II. Fiduciary Liability

Perhaps the most salient regulatory impediment to utilizing annuities to provide retirement income from employer-sponsored plans is plan sponsors' fear of long-term fiduciary liability for selecting an insurer that ultimately fails to meet its obligations. We recommend mitigating the risk of liability by enacting an appropriate statutory fiduciary safe harbor for DC plan fiduciaries that select annuity providers that are highly qualified (i.e., highly rated for financial strength). We also recommend exploring the need for a "universal" independent fiduciary.

A. Background

The Employee Retirement Income Security Act of 1974 (ERISA) obligates plan sponsors and plan officials to comply with fiduciary responsibilities requiring them to act prudently, in the interests of participants, and with a high degree of care and expertise in selecting, monitoring, and deciding whether to continue to retain investment and service providers to the plan. Plan sponsors fear potential long-term fiduciary liability for violating ERISA's high standard of prudence when selecting and retaining an annuity provider. The concern does not stop with actual liability: employers sponsoring 401(k)s commonly worry about class actions aimed at pressuring them into an expensive settlement as an alternative to a more expensive verdict. Plan sponsors often express concern that, if they offer an annuity option (as opposed to paying a cash lump sum), their legal exposure could easily stretch three or four decades into the future, until the last retired annuitant dies. They fear that, even if fiduciaries selected an annuity provider that gave every indication of being fully capable of meeting its annuity obligations, if decades later it became unable to pay, the plan

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[25] How best to address these problems in the annuity market is a difficult question. Many would look for the solution in stronger and more broadly applicable fiduciary standards (as in the DoL fiduciary rule), including fee-leveling requirements. Others would argue that the market will inevitably replace commission-based sales models with fee-only compensation, and that this will go far toward curing conflicts of interest and eliminating excessive annuity lock-in and high surrender fees. Still others would advocate repeal of the Harkin amendment, which prevents the SEC from regulating to protect consumers from indexed annuities. In addition, if the kinds of legislative proposals we advocate here would lead to expanded group annuity purchasing by DC plans, including institutional pricing, it could exert positive pressure on the retail market. Finally, at least some industry representatives would maintain that the annuity market is becoming more civilized, leaving behind the occasional abuses of an earlier era, and curing itself without the need for regulatory intervention. Solving these problems in the market is an important challenge, but one that is beyond the scope of this paper.

[26] See, e.g., Milevsky (2018, 2013).

sponsor could face ERISA fiduciary liability for having imprudently retained that provider. In view of the long-term commitment (including high surrender charges that make it costly to get out of an annuity), a fiduciary's selection of an annuity option is commonly seen as entailing greater risk and lock-in for consumers than more common, liquid plan investments such as mutual funds. These considerations have discouraged many 401(k) plan sponsors from offering annuities.

Department of Labor (DoL) regulations provide guidelines for DC plan fiduciaries selecting annuity providers for "benefit distributions." The regulations describe a series of analytical steps fiduciaries must take to satisfy ERISA's prudence requirement when selecting an annuity provider.[27] The regulations appear to require employers to make assessments and determinations of insurance companies' long-term financial strength that are beyond most employers' reasonable capacity, although they call upon employers to consider retaining an independent expert to advise them. They also require fiduciaries to "appropriately consider" insurer financial capability and cost, and "appropriately conclude" that the insurer is in fact financially capable and that costs are in fact reasonable. While use of the term "appropriately" helps ensure that the fiduciaries' analyses are not cursory or otherwise inadequate, it also leaves fiduciaries uncertain whether they have complied. Accordingly, while labeled "safe harbor" regulations, they are not sufficiently objective to satisfy plan sponsors' desire[28] for a safe harbor in the traditional sense, i.e., a simplifying decision rule or process specifying definitive, objective, and readily ascertainable steps fiduciaries can follow to be sure they have "checked the box" and will be deemed to have acted prudently in selecting an annuity provider.

As an alternative to DoL regulations, the insurance industry for some years has proposed a simple, straightforward, and objective statutory safe harbor that is one of many provisions included in a legislative package approved unanimously by the Senate Finance Committee in 2016 and a generally similar package passed by the House of Representatives in 2018 and in 2019.[29] However, it has not been widely recognized—including by policy analysts, interest groups, lawyers, actuaries and other industry experts who have not been involved in developing or lobbying for the provision, and probably members of Congress—that the pending legislative version of the long-awaited (and much-needed) safe harbor has

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[27] These include requirements that, to qualify for protection from liability, fiduciaries must engage in an "objective, thorough, and analytical search for" providers, must "appropriately consider information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract," and "appropriately conclude that, at the time of selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable…" and thereafter continually review the appropriateness of that conclusion. Employee Benefits Security Administration (EBSA) (2008a, 2008b). See also the preceding DoL (1995) guidance.

[28] In our view, a fiduciary safe harbor is not only desired but needed—not as a legal matter but as a practical matter. The existing standards, including DoL's regulations, Field Assistance Bulletin 2015-02, and the application of ERISA's statute of limitations provide sufficient guidance to enable responsible plan fiduciaries to select annuity carriers without undue fear of liability. Many plan sponsors have unhesitatingly selected highly-rated insurers under these traditional fiduciary standards to annuitize their DB pension obligations, driven by incentives to reduce balance sheet pension liabilities and extricate themselves from DB obligations. The DC context, however, is different. Insistent 401(k) sponsor concerns about the risk of ERISA fiduciary liability for selecting an annuity provider that ultimately goes insolvent have operated much like a self-fulfilling prophecy. Many employers are genuinely concerned; many others find the risk of liability a convenient reason to avoid the cost or trouble of offering annuities. In any event, the industry narrative regarding a need for a safe harbor to limit fiduciary risk has become so entrenched that progress on offering annuities in 401(k) plans will not occur without one.

[29] See the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE) (2019) and the Retirement Enhancement and Savings Act of 2019 (RESA) (2019) for the most current versions.

no financial strength standard.[30] Under the safe harbor, if a fiduciary receives certain factual representations from the insurer (and meets several other procedural requirements), it would be protected from liability for any losses to participants resulting from an insurer's inability to meet its financial obligations under an annuity contract. Likewise, the fiduciary would be excused from considering the insurer's financial capability to meet those obligations and from concluding that it is capable of meeting those obligations. The representations, however, are quite basic. They could readily be provided by essentially any state-licensed annuity provider that is simply in good standing and not currently (or in the past seven years) officially in trouble with its state insurance department.[31]

As currently drafted, therefore, the proposed safe harbor pending in Congress reads much like a lowest-common-denominator industry-wide trade association consensus among competing insurers. Neither limited to, nor even favoring, financially stronger providers, it grants the same stamp of approval to virtually any annuity provider that has been licensed to do business for seven years—even insurers with below-investment-grade ratings—regardless of relative claims-paying ability. (The bill does not clearly require that any portion of that experience be specific to the offering of annuities.) While providing fiduciaries sufficient clarity and certainty, the safe harbor pending in Congress falls short in protecting retirees, protecting fiduciaries, and remaining true to the policy underlying ERISA's high fiduciary standards.

The pending statutory safe harbor appears to exceed the scope of the DoL "safe harbor" regulation in another way as well: by expanding to encompass accumulation-type annuities designed mainly or largely to serve as tax-favored investments, not merely fixed income annuities that simply pay a regular stream of retirement income. This issue is discussed further in the Appendix, section 4.

B. Proposal: A Fiduciary Safe Harbor That Is as Simple as Possible, but Not Simpler

To address these concerns, the following describes our recommended statutory fiduciary safe harbor for selection of annuity carriers. Where necessary, DoL regulations would then flesh out specific terms of the safe harbor in accordance with the statutory guidelines.

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[30] The authors raised the issue when presenting a summary of the proposals in this paper at an April 18, 2019 conference at the Brookings Institution. The Appendix compares our proposals to pending legislative provisions and makes the case for including a "highly qualified" (financial strength) standard.

[31] Specifically, the insurer must represent that it is licensed to offer annuity contracts, has been operating for the past seven years under a current certificate of authority from its state regulator, has filed audited financial statements, has reserves that meet state statutory requirements, undergoes a financial examination by the state every five years (a typical state requirement), and is not operating under an order of supervision, rehabilitation, or liquidation. See RESA section 204; SECURE section 204. To obtain the protection of the safe harbor, fiduciaries also must engage in an "objective, thorough, and analytical search for the purpose of identifying insurers from which to purchase annuity contracts," must consider the contract's cost in relation to its benefits and features and must conclude that the cost is reasonable.

1. Appropriate Scope of Safe Harbor

The safe harbor would be unambiguously limited to selection of the annuity carrier based on its financial strength and stability; it would not apply to fiduciaries' decisions regarding the type, price, or other terms of annuity contracts.[32] Those decisions would continue to be subject to ERISA's regular fiduciary standards, but the safe harbor would streamline the full fiduciary analysis normally required to prudently select an insurer. It would enable plan fiduciaries to rely on appropriate third-party factual information (though often transmitted through insurer representations) instead of making a full independent analysis of the insurer's financial capability to meet its annuity contract obligations.

2. A Meaningful Quality Standard

A fiduciary safe harbor should include a meaningful quality standard—expressed through simple, objective indicators—relating to insurers' financial strength.[33] A safe harbor that appears to include substantially all providers (that have been licensed for seven years) without regard to their financial strength or creditworthiness would be politically expedient—a quick fix facilitating consensus within insurance industry trade associations. But ultimately it might not be doing a service to participants, plan sponsors, or even insurers collectively. It is less likely to maximize protection of employees and retirees, deter litigation, protect fiduciaries from liability or large settlements, or impress plan sponsors as credible and sustainable. A safe harbor without a meaningful financial strength standard means that plan sponsors offering annuities might well feel compelled to incur the cost of engaging an independent expert consultant to do almost as much as is required today to help narrow a field of hundreds of insurers that would qualify under such a safe harbor.[34]

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[32] Earlier versions of the pending legislative safe harbor proposal were broader in scope or were ambiguous on this point. At the suggestion of one of the authors of this paper, the pending legislative language was clarified (though not completely). While a recent Joint Committee on Taxation (2019) description incorrectly described the scope overbroadly, that document is not part of the official legislative history, and a later House Committee report, Committee on Ways and Means (2019), which is official legislative history, has sought to set the record straight by clearly stating that the scope is specifically limited to selection of the annuity provider.

[33] Generally, references here to "financial strength" and "claims-paying" ability are intended to be used interchangeably.

[34] For some of these reasons, the 2018 ERISA Advisory Council Report, while supporting the need for a fiduciary safe harbor, refrained from endorsing or supporting the particular approach taken in the RESA fiduciary safe harbor proposal. The Council observed that "the bill tries to change ERISA's current safe harbor provision [referring to DoL's 2008 regulation, which is called a safe harbor but, in our view, is not sufficiently clear-cut and objective to provide certainty] to mitigate employer concerns about adding an annuity option to their retirement plan offerings." Advisory Council on Employee Welfare and Pension Benefit Plans (ERISA Advisory Council or Council) (2018), p. 35. The Council's Report noted that the American Council of Life Insurers (ACLI) supported the RESA safe harbor proposal and that "a few witnesses" (referring specifically to two witnesses, both representing insurance companies) also favored such an approach. P. 33. However,

> "[o]ther witnesses expressed concerns about relying solely on state insurance regulators' certification. Mr. Reish asserted that this approach is not sufficiently protective, noting that oversight quality varies considerably by state. Other witnesses noted that reliance on state insurance guarantee funds could leave participants without adequate coverage if an insurance company defaults. Ms. Dudley of ABC and Ms. Leahy of Siemens suggested that plan sponsors would want more due diligence than simply relying on state certification. Ms. Leahy noted that Siemens would not likely rely on the safe harbor elements of RESA, but rather turn the annuity selection decision over to an independent fiduciary. For smaller plans, this potentially added expense would be a deterrent to using insurance company guaranteed products in LTI [lifetime income] options." P. 33

The Council's Report added the following footnote to the sentence quoted in the preceding paragraph that ends with the reference to "simply relying on state certification": "Further, the 2018 Council notes that, in 2012, a representative of the regulators

In our experience, regulatory safe harbors generally are not and should not be designed to lower basic statutory or statutorily-derived standards (such as financial strength, in this case). They are designed instead to simplify the process of applying standards, making the process less costly, faster, more objective, and therefore more certain.[35]

The commercial annuity market—even where ERISA does not apply—ordinarily gives careful attention to insurers' relative financial strength (as shown below). To cite just one example, the Alliance for Lifetime Income provides the following Question-and-Answer on its website: "How do I know that my protected income is safe?" "All insurance companies have a rating for financial strength provided by rating agencies like A.M. Best, Standard & Poor's, Moody's, and Fitch. Ask your financial advisor about the financial ratings of the insurance company you are considering"[36] But where ERISA's exacting fiduciary standards apply, it is all the more important to focus on financial strength. Since the market and ERISA fiduciary analysis cannot and do not turn a blind eye to relative claims-paying ability (see Appendix, sections 1 and 2), neither should an ERISA safe harbor.

3. Simplified Indicators of Financial Strength/Claims-Paying Capability

A meaningful standard of quality would maximize the likelihood that benefit promises will be backed by insurers that are experienced in providing annuities and are among those with the greatest claims-paying capacity. Accordingly, our proposed safe harbor would be limited to insurers that are very strong financially. While this need not be "the safest available" annuity in the market (which is how DoL has described the DB plan standard), it should be at least among the safest. To be workable, the safe harbor would streamline the process of distinguishing among annuity providers based on financial strength (or claims-paying ability) with reference to the financial strength ratings assigned by the leading Nationally Recognized Statistical Rating Organizations (NRSROs), which are registered with the SEC and which it oversees and examines.[37]

Our proposed inclusion of a high financial strength standard is in no way limited to a plan's selection of a single annuity provider. It is equally applicable when a plan selects multiple providers, such as multiple highly-rated insurers to diversify any solvency risk, or gives participants access to an annuity quotation and purchase platform to collect real-time

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themselves – the National Association of Insurance Commissioners (NAIC) – opined this would not be a good idea—"In response to a question from the Council, Ms. McPeak [of NAIC] noted that she did not believe it would be sufficient to establish a safe harbor based solely on the fact that a life insurance company and annuity provider is licensed in a state." P. 33, n. 33.

[35]This commonly means that safe harbors reward, with simplification of process and certainty, decisions that are clearly well within the boundaries of the generally applicable standards. This typically is based on carefully selected, simplified indicators suggesting that, if the generally applicable standards were applied, they would almost certainly be satisfied. Accordingly, consistent with the commonly held "no free lunch" principle, decisionmakers looking to short-cut the generally applicable full-dress fiduciary prudence analysis can reasonably expect to do so only or chiefly by limiting themselves to easier cases designated by the safe harbor. One who instead wants to walk up to the edge of the permissible zone—pushing the envelope to take a position on a close case—can take the additional trouble to engage in the full fiduciary analysis. As experienced ERISA counsel have noted, "'Safe harbors' are ordinarily viewed as creating a higher standard than what the law requires, that is, fiduciaries may satisfy their obligations in ways other than by following the [safe harbor]." Reish and Ashton (2017), Appendix D, p. 33.

[36] The Alliance for Lifetime Income is an organization consisting of major insurance companies and investment firms seeking to educate consumers and advisors about the value of commercial annuities for retirement income. See Retirement Checklist Q&A-8 at www.allianceforlifetimeincome.org.

[37] U.S. Securities and Exchange Commission (2017).

quotes and promote continual, ongoing competition among multiple highly-rated insurers to provide the best value.

Whatever the format, the annuity market generally does not stop with the basic question of whether an insurer is licensed; it does not treat all licensed life insurers as essentially undifferentiated in terms of financial strength. Rather the market has shown considerable demand for insurer financial strength and credit ratings as determined by NRSROs that for decades have been in the business of researching and providing such carefully differentiated assessments.[38] To be sure, certain NRSROs have come in for sharp criticism and distrust based on their role in, and lack of independence before and during, the Great Recession.[39] Their high ratings of collateralized debt obligations proved to be disastrously unreliable, and Congress recognized that most existing rating services are conflicted because they are paid by the companies they rate (or in some cases by owners of the investments being rated).[40] In fact, Congress responded in the Dodd-Frank[41] legislation by requiring each federal agency, "to the extent applicable," to review and modify its regulations "to remove any reference to or requirement of reliance on credit ratings" and replace it with some other appropriate "standard of credit-worthiness."[42] But during the ensuing years, at least some lessons have been learned. Efforts have been made (largely pursuant to Dodd-Frank) to improve rating agency practices, including the development and prevalence of risk-based capital standards and the establishment of an Office of Credit Ratings within the SEC to provide oversight of NRSROs.

Accordingly, it is unclear that the problems affecting the pre-2009 credit ratings of mortgage-backed securities are likely to apply equally to financial strength ratings of insurance companies in future years. Therefore, in a world with few benchmarks or comparable centers of expertise regarding financial strength and creditworthiness, we question the justification for dismissing entirely the work of all of the NRSROs.[43]

Put simply, the issue is not whether financial strength ratings are fallible—of course they are (as are the state insurance departments and everything else in the regulatory process)—but whether on net they would add value to a safe harbor. Recognizing the rating services as a potentially useful resource, an annuity provider in good standing with state regulators would qualify under the safe harbor only if it had high financial strength ratings from the major national NRSROs[44] and sufficient experience in providing annuities. For example, the "highly qualified" standard could require the insurer to have (i) current and

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[38] See Appendix, sections 1 and 2.

[39] White (2018). Some 30 years ago, rating agencies also gave high ratings to insurer Executive Life before it became insolvent. However, this appeared to have resulted largely from rating agencies' failure to take into account the fact that, while that insurer appeared to be very well capitalized, its own assets were heavily invested in junk bonds. In the ensuing years, the insurance industry has adopted risk-based capital analysis, which is designed to prevent this kind of error in the future.

[40] NRSROs are now required to disclose potential conflicts of interest and to address and manage them pursuant to written policies and procedures that they maintain and enforce. U.S. Securities and Exchange Commission (2017).

[41] Dodd-Frank Wall Street Reform and Consumer Protection Act.

[42] Dodd-Frank sections 939, 939A.

[43] Four NRSROs have substantial shares of the market for life insurance company ratings: A.M. Best Company, Inc., Fitch Ratings (formerly Duff & Phelps), Moody's Investor Services, and Standard & Poor's Insurance Ratings Services. No other NRSROs perform a comparable number of these ratings.

[44] The risk of false negatives (erroneously low ratings) here is much smaller than the risk of false positives (erroneously high ratings).

recent financial strength ratings, provided by at least two of the four major NRSROs, that are in the NRSROs' top few ratings categories,[45] and (ii) no lower financial strength rating from any NRSRO. Because each NRSRO has its unique scale of rating categories and letter ratings, without any alignment or correspondence among them, Congress could direct DoL, in consultation with the Treasury Department (which houses the Federal Insurance Office), the SEC (which includes the Office of Credit Ratings), and perhaps other neutral experts, to specify, to the extent necessary, roughly comparable thresholds for each NRSRO, and otherwise fine-tune the financial strength ratings standards. To support this, insurers' representations would include (i) all NRSRO financial strength and credit ratings the insurer has requested and received going back a specified number of years, and (ii) disclosure of which affiliated entities are and are not liable (and how that relates to the ratings).

One existing model for the use of multiple ratings can be found in the COMDEX composite index. For more than 500 insurers, COMDEX reports the rating provided by each of the four major NRSROs, determines each insurer's relative ranking by each NRSRO, and then combines those relative rankings into a single composite ranking calculated similarly for each insurer on a scale of 1 to 100.[46] Accordingly, an alternative approach might limit the safe harbor to insurers whose most recent COMDEX rating is above a specified threshold or might direct DoL to apply its own similar method of combining the NRSRO ratings.

It would be fair to ask why a safe harbor needs to include a standard higher than the level of adequacy state regulators normally require to license an insurer and permit it to continue in business. The answer is that, to protect retirees,[47] ERISA requires DC plan fiduciaries to select annuity providers in accordance with ERISA's prudent expert fiduciary standard—which the courts have characterized as "the highest known to the law."[48] As noted, a new fiduciary safe harbor automatically approving virtually any insurer that has been in business for seven years (except the few that are not in good standing with their state regulators) would amend ERISA to effectively confer automatic approval on hundreds of insurers that have not achieved "superior", "excellent" or "very strong" financial strength ratings. It would even sweep in many insurers with speculative-grade (equivalent to "junk bond") ratings as well as others that are only marginally investment grade.[49]

Unless limited in some way to highly-rated insurers, a safe harbor based merely on insurers' representations that they are in good standing with their state insurance department would be inconsistent with a "best in class" approach reflecting ERISA's high fiduciary standards. In the long term, it may not be wise or sustainable to allow such representations to substitute for an objectively ascertainable, expert and independent third-party rating of each insurer's financial capability. While most NRSROs are not or might not be sufficiently independent, they are experienced and expert, and, for now, they may be all we

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[45] Example: the top three categories at A.M Best and the top four categories at Moody's, Standard & Poor's, and Fitch.

[46] See EbixExchange (2007). Each insurer's overall ranking corresponds roughly to a percentile score reflecting a composite of its relative rankings by each NRSRO. Such an approach also would need to give special attention to the appropriate application of financial strength ratings to specific entities as opposed to controlled groups of companies.

[47] The American Academy of Actuaries is among those who point out that it is not only the state insurance departments that protect annuitants from the risk of nonpayment. "Insured annuities are issued by insurers and provide guaranteed payments. There is a risk of nonpayment or reduced payment, but that risk is mitigated by the strength of the insurer (its ability to pay claims) as well as requirements from regulators." American Academy of Actuaries (2015), p. 3.

[48] Donovan v. Bierwirth, 680 F.2d 263, 272 (2d Cir. 1982).

[49] Debt obligations rated below investment grade have often been colloquially referred to as "junk bonds."

have. Moreover, as described in the Appendix, sections 1 and 2 (which further specifies this proposal and its rationale), steps have been taken, and further steps might be taken, to improve, for this purpose, the rating agencies' independence or procedures or to provide additional oversight.[50]

Requiring high ratings in addition to other safe harbor conditions would hardly be a novel or untried approach. Previous DoL rulemakings on selection of annuity providers[51] and prohibited transaction exemptions (as well as numerous other precedents and examples in regulations and some statutes) have also relied upon ratings, as described in the Appendix, sections 1 and 2.

C. A Universal Independent Fiduciary?

As currently interpreted by DoL, ERISA's fiduciary standards look to each plan sponsor to engage its own expert consultant or independent fiduciary to assess and advise on the identical factual issue—the long-term financial strength of each interested insurance company. (In-house fiduciaries who have the requisite expertise may make these assessments on their own.) Because this issue does not vary depending on which plan is asking the question, it is unnecessary and inefficient to expect each of many plans to pay for its own independent expert to perform the identical analysis based on the same public information. As suggested, for purposes of a fiduciary safe harbor, NRSRO financial strength ratings (while imperfect) are the best available simple stand-in for a full fiduciary analysis of claims-paying ability. However, as a possible eventual replacement or alternative to such ratings as a key element of a safe harbor, a strictly independent, expert, non-profit entity might perform this analysis for any and all plans. For example, the Labor Department's safe harbor guidance could refer to, evaluate, or assist in establishing or certifying such an expert panel or entity to serve as a kind of universal independent fiduciary to advise solely on the financial strength of annuity providers.

Instead of establishing a new entity, the role of universal independent fiduciary for insurer financial strength could conceivably be delegated to DoL (the Employee Benefits Security Administration), the Treasury Department (Federal Insurance Office), the Consumer Financial Protection Bureau, the SEC (Office of Credit Ratings), or the Federal Trade Commission. That said, for this purpose each of these options—and, for that matter, any

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[50] Some will object that a quality standard in a safe harbor means the government will be "picking winners and losers." But ERISA's exacting fiduciary standards call for plan fiduciaries (as distinct from the government) to make precisely this kind of discriminating judgment. In fact, DoL regulations continue to require DB plan fiduciaries to choose the "safest annuity available" and make clear that ratings provided by insurance rating services (private-sector entities) are a key factor (though by no means the only factor) to consider in determining claims paying ability. 29 CFR section 2509.95-1(c). Moreover, the approach being explored here for a DC plan annuity provider selection safe harbor would be far less stringent than the "safest available" standard in effect for DB plans.

[51] The preamble to DoL's 2007 proposed fiduciary safe harbor regulation explained that, in evaluating an annuity provider's claims paying ability and creditworthiness, the regulation "requires that the fiduciary consider whether an annuity provider's rating (as determined by an appropriate rating service(s)) demonstrate or raise questions regarding the provider's ability to make future payments under the annuity contract" and "requires that the fiduciary consider the availability of additional protections [through the state guaranty associations] and the extent of their guarantees." EBSA (2007). In response to insurance industry opposition, the final regulations in 2008 eliminated the requirement to consider ratings, although the preamble stated that, "in many cases, 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" and that "information regarding additional protections that may be available through a state guaranty association for an annuity provider also would be useful information to a plan fiduciary." EBSA (2008b).

governmental agency—has substantive or political drawbacks. Alternatively, one or more existing professional organizations or other non-profit entities might conceivably set up a panel of independent experts with a dedicated staff that might include detailees from NRSROs. Staffing and other costs could be limited because the mission would be far narrower than that of the NRSROs: simply assessing which insurers, among those that meet the basic licensing requirements imposed by state insurance departments, have sufficient financial strength to be selected under an ERISA fiduciary safe harbor.

The independent entity or panel would not need to "reinvent the wheel" in rating the claims-paying ability of annuity providers; it could take note of or in some measure rely upon (though not uncritically) NRSRO ratings in arriving at its own, independent conclusions. It could determine how to take into account the different NRSRO rating scales or perhaps devise its own rating scale to assess financial strength for DC plan annuity purposes. Ratings would not be funded or controlled by insurance companies. Instead, the independent board, which might be publicly funded, would determine which annuity providers it rates, taking into account interest or requests from plan sponsors. It would not be a guarantor. Its ratings or other determinations would not be binding on plan fiduciaries (but would carry considerable weight and might even be determinative in a safe harbor context), and its personnel would be protected from liability.

Alternatively, the independent entity might contract with NRSROs to have them perform annuity provider financial strength rating assessments expressly for DC plan ERISA fiduciary purposes. The assessments would be performed in accordance with appropriately rigorous guidelines and procedures, prescribed by the independent fiduciary entity, designed to preclude "rating shopping" and undue control or influence by insurers. Each insurer wishing to offer annuities to ERISA-governed DC plans might, for example, be required to be evaluated and rated in this manner by at least two contracting NRSROs. Alternatively, short of contracting for ratings, the independent entity might conceivably condition the use of ratings for these purposes on NRSRO agreement to comply with specified procedural requirements.

Precedents for such independent, expert, advisory entities exist in other regulatory spheres.[52] Support for such an approach, based on applicable metrics, can be found in a Treasury Department report issued during the first year of the Trump Administration and in a 2016 Report of the Bipartisan Policy Center's Commission on Retirement Security and Personal Savings.[53]

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[52] Examples might include, among many others, the National Institute of Standards and Technology or the U.S. Preventive Services Task Force. The USPSTF, an independent body consisting of national experts in preventive medicine, makes recommendations regarding clinical preventive services that are relied upon by health regulatory agencies in implementing statutory requirements. Another example is the Public Company Accounting Oversight Board, which regulates the auditing of companies and was established after the Enron debacle.

[53] U.S. Department of the Treasury (2017); Commission on Retirement Security and Personal Savings (2016). These are briefly described in the Appendix. In addition, for a different approach to policy regarding annuities, see Gale, John, and Spencer (2012), proposing federal insurance for life annuities (and similar products) that would replace, supplement, or back up the state guaranty funds insofar as they apply to annuities. Pp, 28-31.

III. Annuity Portability

The limited portability of annuities is a second key regulatory concern. A plan sponsor that discontinues offering an in-plan annuity in which employee or employer contributions have been invested interrupts the steady accumulation of annuity benefits. No further contributions would go to the annuity, and in many instances, employees would be subjected to non-trivial annuity liquidation or surrender fees, unless they moved the annuity to another plan or IRA. However, current law generally would prohibit such a distribution from a 401(k) plan.

We recommend a statutory exception to the 401(k) withdrawal restrictions permitting direct rollover of the annuity contract to another plan or IRA to increase portability and make annuities more attractive.

A. Background

While some annuities are offered as distribution options at the time a plan participant retires, others are offered as both an investment and distribution option. Sometimes referred to as "in-plan" or "accumulation" annuities, these products increase in value over time as contributions are invested in the deferred annuity (or deferred annuity "units").

A particular portability challenge arises if a plan offers annuities and then stops doing so. For example, the plan's recordkeeper might stop maintaining the deferred annuity option on its platform or the plan might replace its recordkeeper with a new one that does not offer the annuity product. Alternatively, the plan's fiduciaries might decide that the annuity no longer is a prudent or desirable investment option (for example, if the plan's current annuity provider unfavorably changes the financial terms of its annuities).[54]

If a plan stops offering in-plan accumulation annuities, participants might feel that their future annuity has not accumulated sufficiently to have made the investment worthwhile. A participant might then want to give up and cash out the annuity or might be effectively forced to do so by the action of the plan and the terms of the annuity contract. In either case, the participant could face significant surrender or liquidation charges or other fees.[55] Others might want the option of continuing to add to their previous contributions even if the plan stopped offering the annuity. But if the plan's annuity option was discontinued, contributions generally could not continue to be invested in the product on a stand-alone and similarly tax-favored basis unless the annuity contract was distributed from the plan, and the annuity provider was willing to continue receiving contributions. However, current law restricts most 401(k) and similar plans' ability to distribute benefits resulting from pre-tax contributions of a participant who is still employed by the plan sponsor and is under age 59 ½. (This restriction applies even if the distribution is rolled over to an IRA or another plan.) While many such plans permit hardship withdrawals to active employees,

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[54] Generally, a more common portability issue arises when a participating employee leaves the employ of the plan sponsor. Upon termination of employment, the participant would be free to take a distribution of benefits, including the annuity contract, but a new employer, if it has a plan, might not have a similar annuity offering in its plan or might not accept a rollover or transfer of the annuity. In that event, the individual could still roll the annuity contract into an IRA.

[55] U.S. Department of the Treasury (2016).

these circumstances probably would not ordinarily qualify as a financial hardship; and even if they did, hardship withdrawals cannot be rolled over.

B. Proposal

To address this portability problem affecting in-plan annuities, we propose legislation carving out an exception to the 401(k) plan withdrawal restrictions to allow a participating employee, absent any other distributable event, to withdraw and directly roll over an in-plan annuity to an IRA or another employer plan that would accept the annuity.[56] The legislation would also exempt the withdrawal from the ten percent additional tax on early withdrawals.

This would enable participants to continue holding the annuity and adding to it (accumulating additional deferred income units, for example). Plans would not be permitted to make such a special withdrawal election available, however, unless the annuity was no longer authorized to be held as an investment option under the plan or participants' ability to invest in it was suspended indefinitely. To prevent the special exception from being used solely to benefit one or a few individuals, the withdrawal event should be limited to cases in which a lifetime income investment is no longer available to all or a broad class of participants.

IV. RMD Rules

The required minimum distribution (RMD) rules applicable to tax-favored DC plans and IRAs create additional obstacles. While they are used by some as a rough-and-ready, de facto decumulation strategy, the RMD rules are complex, not designed to optimize decumulation, poorly targeted, and enforced by a whopping 50 percent tax penalty.

We propose a comprehensive package of provisions to bring the RMD rules into closer alignment with their purposes: exempting those to whom the rules need not apply, closing a key loophole, and simplifying and reforming the rules in a progressive way.

A. Background

RMD rules generally require participants in most tax-qualified retirement plans and IRAs to begin removing assets from the plan beginning soon after they reach age 70 ½. The benefits are required to be distributed, in accordance with regulations, over the partici-

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[56] Conceivably, such a provision might also allow employees to withdraw the annuity without rolling it over to an IRA or plan and without surrendering or liquidating it. The employee could then continue holding and investing in the annuity even though it would have "leaked" outside of the tax-favored retirement system. However, in the interest of minimizing leakage of retirement benefits, we believe the relief should be conditioned on direct rollover.

pant's life or life expectancy (or joint lives or life expectancies of the participant and participant's spouse or other beneficiary), or more rapidly.[57] Savers need to take only a small share of their assets each year in order to comply (generally a fraction of the account balance each year that is calculated to distribute the entire account ratably over the individual's or married couple's remaining life expectancy). For example, the RMD rules require married retirees turning age 70½ to distribute only 3.65 percent of their retirement savings as the first year's distribution (and less if the spouse is more than ten years younger than the retiree). The percentages increase gradually as retirees age.[58] The rules do not actually require participants to stop saving and begin consuming amounts required to be distributed, only to remove them from the tax-deferred plan or IRA so that they will be taxed currently and will no longer benefit from tax-deferred accumulation.

DC plans and IRAs are subject to RMD rules that differ from those applicable to DB plans and qualified plan annuities. Roth IRAs are exempt from lifetime but not post-death RMDs; Roth 401(k) accounts are not exempt from RMDs at all. Related to the age 70 ½ RMD commencement deadline, traditional IRAs may not accept new contributions after that age, but qualified plans and Roth IRAs are not subject to that restriction.[59] Special and complicated RMD rules apply after the account owner's death, varying based on whether the account holder died before RMDs began, the type of beneficiary (or beneficiaries), and other factors.

Since they are not designed to serve as guidelines for optimal asset decumulation, the RMD rules can restrict planning and can impede the optimal use of savings. While the one-divided-by-life-expectancy (annually recalculated) approach prescribed by the RMD rules is far from the worst rough rule of thumb for decumulation that might be devised, it also is not good enough. In practice, many retirees might misinterpret the taxation pattern prescribed by the RMD rules as officially endorsing an optimal consumption pattern (minimum and maximum), and this is one reason why apparently the rules often affect the pace at which balances are withdrawn.[60] Yet the regular RMD pattern does not match most retirees' needs or desires—which of course are neither uniform nor consistent from year to year—and does not lend itself to dynamic drawdown planning based on periodic reassessments reflecting changes in circumstances. Social Security already provides a relatively inflexible income stream; private-sector retirement savings need not follow suit. In addition, because the RMD rules apply a fraction (one divided by the annually recalculated life expectancy, in years) each year to the current account balance, they automatically translate annual market losses or gains into proportional annual retirement pay cuts or raises, which can be disruptively volatile.

The RMD rules also are poorly targeted. They are intended chiefly to help ensure that tax-advantaged retirement benefits are used for their intended purpose—increasing financial security in retirement—rather than for estate planning purposes, to transfer wealth tax-free across generations. Wealthy individuals already disproportionately benefit from tax-advantaged retirement accounts, and, with more savings than they need to maintain their

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[57] A single lump-sum distribution also complies.

[58] The percentages increase to roughly 4%, 5%, 6%, 7%, and 8% at ages 73, 79, 83, 86, and 89, respectively, and continue increasing thereafter. See Internal Revenue Service (2018), Appendix B: Table III, Uniform Lifetime Table.

[59] See U.S. Department of the Treasury (2013), pp. 215-216.

[60] See Forman (2018).

standard of living, can benefit from letting their tax-favored retirement plan balances continue accumulating untaxed returns for as long as the law permits. In fact, affluent retirees and their advisors have long been exploiting weaknesses in the RMD regime to achieve substantial cross-generational tax deferral. Additionally, the 50 percent excise tax on noncompliance ultimately threatens mainly retirees with modest resources who misinterpret or fail to understand the rules and who cannot afford to delegate compliance to personal financial advisors or CPAs.

A one-year RMD holiday in 2009 served as a natural experiment showing that retirees with greater assets—as well as the typically wealthier retirees who choose to take their RMDs annually instead of monthly—were more likely to take advantage of the holiday by suspending distributions. [61] This provides further evidence that retirees with less accumulated wealth tend to depend on ongoing plan distributions for financial support; ordinary retirees commonly are neither interested in nor in a position to adhere to a strategy that maximizes tax deferral. [62]

For these reasons, the legitimate policy goal of preventing the misuse of retirement tax preferences for estate planning is not efficiently advanced by taxing a prescribed portion of ordinary retirees' savings annually pursuant to inflexible rules that can be complex, confusing, and costly to comply with.[63]

B. Proposal

To address these concerns, a comprehensive package of provisions could bring the RMD rules into closer alignment with their purposes by exempting those to whom the rules need not apply, closing a key loophole, and otherwise reforming the rules in a progressive manner. We propose the following steps to reform the existing rules to reduce their burden, reduce noncompliance, and reduce the number of individuals affected or threatened by the stiff enforcement penalty.

1. Exempt Ordinary Retirees from RMDs

Accordingly, we propose to better target the RMD rules by totally and permanently exempting from RMDs those retirees with average or below-average assets.[64] As noted, those retirees are likely to be relying on their savings to finance current or upcoming consumption, . . .

[61] Brown, Poterba, and Richardson (2017).

[62] There is evidence that most retirement savers who do not take a lump sum payout take a distribution in a given year equal to their RMD. An Employee Benefit Research Institute study suggests that only 25 percent of retirement savers who did not take lump sums took more than the RMD, indicating that 75 percent either took the exact RMD or failed to comply. See Copeland (2018).

[63] Brown and Turner (2018).

[64] Most previous proposals to reform RMDs have not focused on progressivity or on encouraging lifetime income. See Brown, Poterba, and Richardson (2017); Brown and Turner (2018); Soled and Wolk (2000). For example, the pending SECURE and RESA bills would postpone the required beginning date from age 70½ to age 72 and, eventually, age 75 to preserve more assets under management for investment firms and financial advisors and extend potential tax deferral for more affluent retirees. Because it would maximize tax-favored assets under management and extend tax deferral, its projected revenue cost was very high and therefore, if paid for, would require painful offsets. The oft-repeated justification is a need to keep up with increases in life expectancy. However, given the purpose of the RMD rules, it is unclear whether there ever was any compelling logic in the

to be making relatively consistent withdrawals without regard to the RMD rules, and to exhaust their account balances over the course of their lifetime. Therefore, exempting them would reduce their compliance burden and lose less revenue than relief for the affluent.[65] We recommend that the specific maximum aggregate balance (qualified plans and IRAs) needed to qualify for the exemption be set at $100,000 as of age 70 (phasing out ratably over the next $10,000) with a view to exempting at least a majority of retirees, but the amount should be adjusted upward (not to exceed $250,000) or downward depending on the affordability of the estimated revenue cost.

2. Close the Stretch IRA Loophole

We propose to offset the revenue cost of this proposed exemption (at least in large part) by closing a sizable gap in the RMD regime: the extended period currently permitted for post-death distributions to many heirs. This enables wealthy retirees to pass their retirement savings down to later generations at a reduced tax rate. In many cases, for example, young grandchildren inherit the plan account or IRA from a wealthy deceased grandparent and stretch the RMDs out over their entire lifetime (hence known as a “stretch IRA”). We propose to generally require distribution of retirement account assets upon the owner’s death or within five years thereafter.[66]

We also recommend the following additional statutory changes to simplify and otherwise improve the RMD rules and reduce taxpayer burden.

3. Require Regular Updating of Life Expectancy Tables

Another useful, but much smaller, change to the RMD rules would update the RMD life expectancy tables. While Congress has the authority to change the statute (i.e., change the fundamental structure of RMDs or exempt certain savers from the rules), Treasury has the authority to adjust the life expectancy tables in the RMD regulations. In 1987 and 2002, the Treasury Department used its authority to update and simplify the life expectancy tables to reflect increased life expectancies in the U.S. The tables have not been similarly updated since then,[67] but a 2018 Trump Administration Executive Order[68] directed Treasury to determine whether the life expectancies used in the RMD regulations are requiring unduly large withdrawals and should be updated, and whether updates should be made annually or on some other periodic basis. Given net gains in life expectancy since 2002,

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first place to postponing RMDs until over half a decade after most people retire. The burden of compliance, weighing more heavily on the less affluent, would also not be eliminated but only deferred to age 75.

[65]We believe such an exemption was first proposed in 2013 in the Obama Administration budget proposals. It would have exempted retirees with aggregate plan and IRA accumulations by age 70 ½ of less than $75,000 (phasing out between $75,000 and $85,000), later increased to $100,000 (phasing out up to $110,000). At the time, this was estimated to be sufficient to exempt a majority of seniors with retirement savings. The proposal was then introduced by now Ways and Means Committee Chairman Neal (with a $250,000 cap) and later was included in the 2018 Republican-proposed Family Savings Act with a $50,000 cap.

[66] To the extent this could drive the beneficiary into a higher marginal income tax bracket, Congress might consider allowing use of a five- or ten-year income tax averaging convention.

[67]While the tables have not been updated, Treasury exercised its existing authority in 2014 to issue regulations exempting QLACs from RMDs and thereby making it feasible for them to be offered in the nearly $17 trillion qualified DC plan and IRA market.

[68] Executive Order No. 13847 (2018).

updated tables would afford retirees slightly more flexibility in drawing down their savings, although the impact would be small.[69] That said, we propose that Congress direct the Treasury Department to update the RMD life expectancy tables at least every five years to reflect any changes in life expectancy. While this likely would have only a small impact, it is sound policy because tax parameters should generally be updated to reflect changes in the economy.

4. Require IRA Trustees to Automatically Calculate RMDs

Qualified plan administrators are responsible for calculating RMDs for their retirees who still have benefits in the plan when they reach age 70. However, retirement funds have continued increasingly to roll over from plans to IRAs, whose trustees and custodians are not required to do so. IRA trustees are required only to notify the retiree that the RMD rules apply and offer to perform the calculations if requested. Not surprisingly, many IRA owners in their seventies or older fail to read these notices and are unaware of this offer or, in many cases, are unaware of the RMD rules. We propose, therefore, that IRA trustees and custodians be required not only to inform retirees of their RMD responsibilities but also to automatically calculate and distribute the RMDs for their customers. IRA owners who wish to use some of their IRAs to satisfy the RMDs for their other IRAs can so inform the IRA trustees and specify the amounts they want distributed. IRA trustees would be protected from any responsibility that depends on knowing about any other IRAs or IRA balances owned by the same individual.

5. Simplify and Harmonize Roth and Traditional IRA Age 70½ Distribution and Contribution Rules

As noted earlier, the RMD rules apply to qualified plan accounts, including Roth 401(k) accounts, as well as traditional IRAs, but Roth IRAs are exempt from the lifetime RMD rules. While not compelled by sound retirement or tax policy, this gives Roth 401(k) participants an incentive to roll over plan benefits to a Roth IRA (or save in a Roth IRA instead of a plan) to avoid RMDs (even though ERISA-governed qualified plans more often offer participants lower fees, carefully curated investment options, and professional fiduciary oversight). Accordingly, we propose to harmonize the RMD rules to apply in the same way to all IRAs and qualified plans by eliminating the special Roth IRA RMD exemption.[70] Existing Roth IRA balances would be grandfathered to protect reliance on the current exemption.

At the same time, we would harmonize the difference in treatment of contributions to traditional IRAs (prohibited after age 70 ½) as compared to Roth IRAs or qualified plans (no such prohibition) by permitting post-age-70 ½ contributions to traditional IRAs. The . . .

[69] For example, Gleckman (2018) notes that such updating would reduce the first year's RMD for those aged 70 ½ from 3.65 percent to 3.45 percent of their balances—making only a negligible difference in their retirement finances.

[70] See U.S. Department of the Treasury (2016), pp. 145-146. While qualifying distributions from Roth IRAs are tax-exempt, the requirement to distribute a portion of the Roth IRA balance each year after age 70 ½ would meaningfully reduce tax benefits by gradually stopping the accumulation of tax-free earnings in the Roth IRA.

rationale for prohibiting contributions after 70 ½ simply because RMDs are required to begin is not compelling: the prohibition does not apply to other types of plans, most of which are also subject to RMDs, and the choice to continue saving may be increasingly meaningful as people work and live longer.

6. Clarify That the RMD Rules Do Not Permit DB Buybacks of Ongoing Life Annuities

An additional RMD reform would direct Treasury and IRS to amend the RMD regulations to make clear that DB plan sponsors generally are not permitted to offer to buy back from retirees ongoing DB plan life annuities in exchange for lump sum payments.

A number of the DB plan sponsors that have been seeking to "de-risk" their balance sheets by cutting back on existing DB plan liabilities have been advised by consultants that they might reduce DB liabilities and participants by offering to buy back lifetime annuities from retirees who have been receiving them (in some cases for many years). A retiree who accepts the offer to cash out his or her DB lifetime retirement income might find that, upon seeking advice from a financial advisor regarding the optimal investment of the resulting lump sum payment, some advisors recommend using at least a portion of the lump sum to purchase a commercial annuity (at a retail premium cost that did not apply to the DB plan annuity). For many years, it was generally believed that such buybacks were not permitted, but employer requests several years ago resulted in a number of IRS private letter rulings addressed to specific employers indicating that the buybacks were not prohibited.[71]

7. Enact Other RMD Improvements

Our comprehensive package of RMD reforms would also include a number of improvements (statutory or regulatory) to the regulatory RMD exemption for QLACs.[72] We would also recommend specific limited relaxations of existing RMD regulations that prohibit certain modest increases in annuities. However, as these proposals are beyond the scope of this paper, we leave them to be addressed at another time.

V. Conclusion

Promoting appropriate annuity options in 401(k) and other DC plans is a challenge worth taking on. Greater use of income annuities—by more participants for some portion of their

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[71] In 2015, IRS Notice 2015-49, 2015-30 I.R.B. 79 indicated that these buyouts were not permitted but grandfathered all previous ones. The notice provided that the RMD regulations would be amended by proposed amendments making this clear and requesting public comment. However, Treasury and IRS recently issued Notice 2019-18, essentially reversing course and stating that the regulations now were no longer intended to be so amended, that the question is under further study, that pending further guidance the IRS will not assert that such buyouts violate the RMD rules, and that further private letter rulings would not be issued. See Internal Revenue Service (2015) and Internal Revenue Service (2019).

[72] See note 64, above.

benefits—promises to increase retirement security and provide meaningful help in addressing retirees' decumulation dilemma. DC plans could begin to offer lifetime income to tens of millions of participants, with group purchasing, institutional pricing, economies of scale, and behavioral strategies. To that end, we propose policy reforms to establish an appropriately worker-protective fiduciary safe harbor for the selection of annuity providers, increase annuity portability, and reform the RMD regime. These changes would provide an important start toward restoring the pension to our private pension system. However, they would constitute only the first step toward broader reform in this area: in addition to reducing the complexity, opacity, and cost in the annuity market, much more remains to be done to help savers take a thoughtful approach toward retirement planning.

Appendix

This Appendix provides further background placing our fiduciary safe harbor proposal in context, further detailing its rationale, and adding several more detailed recommendations. Section 1 provides further background and discussion regarding the use of financial strength ratings. Section 2 provides a number of pertinent private- and public-sector examples. Section 3 addresses the scope of the safe harbor. Section 4 discusses a potential limitation of safe harbor coverage to fixed income annuities, as opposed to including variable and indexed annuities. Section 5 addresses a potential safe harbor requirement that insurers have experience providing annuities. Section 6 considers whether risk-based capital ratios should be an element of the safe harbor.

1. Use of Financial Strength Ratings: Further Background and Discussion

Going back at least to 1995, DoL has provided guidance to plan fiduciaries on their selection of annuity providers to make benefit payments to plan participants.[73] The guidance has been focused on the insurers' claims paying ability and creditworthiness, and the ratings have played a leading role. In fact, the centrality of ratings among the factors to consider in the ERISA fiduciary analysis was so obvious to DoL in 1995 that, before even referring to other factors (such as the level of the insurer's capital and surplus, the quality of its underlying investment portfolio, etc.), DoL took pains to make clear that ratings were not *the only* factor to take into account.[74] Since the 1990s, however, private-sector stakeholders have complained that DoL guidance requiring plan fiduciaries to select, in general, "the safest available annuity" on the market ("unless, under the circumstances, it would be in the interest of participants and beneficiaries to do otherwise") was unduly strict and impractical (at least as applied to DC plans[75]) and could expose them to litigation for arguably failing to select the "safest available" annuity (although DoL made clear that multiple annuities might qualify under this standard).

In reaction, the Pension Protection Act of 2006 directed DoL to exempt annuities offered as optional forms of benefit in DC plans from the "safest available" standard. DoL complied, and in 2007 proposed a new regulation, which it termed a "safe harbor," expressly for DC plan annuities. As noted, the regulation, finalized in 2008, requires plan fiduciaries to take certain steps (summarized in footnote 27, above) which, however, are not sufficiently objective and automatic to give plan sponsors the certainty needed in a safe

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[73] The 1995 guidance was prompted largely by the adverse impact on retirement plans of the insolvency of Executive Life Insurance Company.

[74] "[A] fiduciary must evaluate a number of factors relating to a potential annuity provider's claims paying ability and creditworthiness. Reliance solely on ratings provided by insurance rating services would not be sufficient to meet this requirement." U.S. Department of Labor (1995), 29 CFR section 2509.95-1(c).

[75] In 2002, DoL made clear its view that its "safest available annuity" guidance applied to DC as well as DB plans. U.S. Department of Labor (2002).

harbor. The insurance industry then developed and discussed with DoL its proposals, substantially similar to the currently pending proposed statutory fiduciary safe harbor. DoL strongly opposed that approach, but announced that it was seeking to develop a regulatory safe harbor that would seek to provide the requisite certainty for plan sponsors while including standards that would adequately protect participants and their retirement security.[76] However, DoL's work and discussions with the insurance industry and other stakeholders (including the NAIC) were ultimately unavailing.

One key obstacle was Dodd-Frank's prohibition on regulatory reliance on credit ratings. In view of the inaccurate credit ratings' contribution to the Great Recession, the Dodd-Frank legislation required federal agencies to minimize their reliance on credit ratings and substitute other standards of creditworthiness. Accordingly, DoL proposed in 2013 to revise a number of its prohibited transaction exemptions (which relied on the use of credit ratings in various instances) by following the SEC's lead in replacing previous references to high credit ratings by at least one NRSRO with qualitative descriptions.[77]

Meanwhile, however, Dodd-Frank was depriving DoL of a critical tool in formulating a workable annuity safe harbor: protecting plan sponsors from liability if, among other conditions, they limited their selections to insurers highly rated for financial strength. While at an impasse with DoL, the insurance industry eventually negotiated a successful compromise among disparate interests within the industry (such as highly-rated, higher-cost insurers versus lower-rated, lower-cost insurers) and then won bipartisan support for its proposal as part of a multi-faceted legislative package in the Senate Finance Committee. Ironically, Dodd-Frank's ban on the use of credit ratings by federal regulatory and administrative agencies would by no means have prevented Congress from including a highly-rated financial strength standard as a key element of a legislative safe harbor. However, the legislative process moved quickly in the late summer and fall of 2016 without serious engagement on the financial strength ratings possibility, and industry's proposal was adopted by the Senate Finance Committee in 2016 and later passed by the House of Representatives (in 2018 and 2019).[78]

As noted, a safe harbor could improve upon (in our view) the pending legislative proposal by adding an objective quality standard based on insurers' financial strength/claims-paying capacity. It would specify a high ratings level and direct DoL to issue more detailed administrative guidance on the financial strength ratings and any other metrics to flesh out and apply a statutory safe harbor standard limited to annuity providers financially strong enough to be considered "highly qualified." For example, the legislation could direct DoL

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[76] U.S. Department of Labor (2014).

[77] In lieu of relying on the rating categories, the SEC characterized the obligation or company as being subject to only "a minimal amount of credit risk" (former top two categories); "minimal or low risk" (former top three categories); or "no greater than moderate credit risk", "at least average creditworthiness", and "investment grade" (former top four categories) and be sufficiently liquid to be sold at or near fair market value within a specified time. An issuer rated in the highest rating category was described by the SEC as having "the highest capacity" or "an exceptionally strong capacity" to meet its financial obligations. Employee Benefits Security Administration (2013). Even in the face of this statutory requirement, DoL evidenced reluctance to forgo use of credit ratings in fiduciary determinations, noting that "credit ratings have been considered useful for fiduciaries of employee benefit plans in evaluating the credit quality of a particular financial instrument or issuer, as plan fiduciaries frequently do not possess the expertise or resources to engage in" such an analysis. Accordingly, DoL said that it recognized that, "while credit ratings may no longer serve as a basis, or threshold, of credit quality, section 939A of Dodd-Frank does not prohibit a fiduciary from using credit ratings as an element, or data point, in that analysis." EBSA (2013). 78 FR 37572, 37577.

[78] Plan sponsors' concerns about the risk of selection an annuity provider for a DC plan without the protection of a safe harbor provision have not prevented DB plan fiduciaries from selecting annuity providers in numerous cases where there was strong motivation to reduce the DB liabilities on the employer's balance sheet.

(in consultation with Treasury, and after considering any advice from the SEC's Office of Credit Ratings and the American Academy of Actuaries) to determine the combination of financial strength ratings (and possibly credit ratings) that should be required to satisfy such a high financial strength safe harbor standard. In addition, DoL should obtain from insurers specific disclosures of how their corporate structure relates to the insurer's liability to pay claims (e.g., whether the obligated entity is a subsidiary only or includes the parent company or affiliates, and how the ratings apply to these entities).

In addition, it would be worth exploring whether and, if so, how a safe harbor with an appropriate financial strength condition could take into account the applicable guarantees put in place by state guaranty associations as a backup in the event of insurer insolvency, up to the applicable state guarantee limits (often $250,000, but often higher or lower, depending on the state). The limits mean participants' annuities might not be fully covered and make the insurer's claims paying ability even more important, as does the fact that the state guaranty association system—while a significant factor—is unfunded, relies on payment by insurance companies rather than the state or federal government, and has yet to be fully put to the test of major or multiple insolvencies (as opposed to smaller and relatively isolated ones).[79]

Our proposed safe harbor's partial reliance on third-party financial strength ratings has also been advocated by the Bipartisan Policy Center's June 2016 Report of the Commission on Retirement Security and Personal Savings. That report recommended that a "more objective approach to assessing carrier solvency" might consider not only the basic license, accreditation, and good standing factors included in the current proposed statutory fiduciary safe harbor but also "*insurer-financial-strength ratings from third-party analysts*."[80] (Emphasis added.)

Moreover, both our recommendation that the safe harbor direct fiduciaries to rely in part on third-party financial strength ratings and our suggestion to explore the possibility of using a universal independent fiduciary approach find support in a 2017 Treasury Department report. The report notes that, "[d]espite the benefits that annuities can provide, they are not widely offered in defined contribution plans" and observes that the fear of liability under ERISA is "the principal deterrent to offering an in-plan annuity option." It recommends that Treasury and DoL "develop proposals on how to establish or certify one or more expert, independent fiduciary entities to assess the long-term financial strength of annuity providers." Such assessments "could be in the form of ratings or other specific metrics," and "could assist ERISA-governed plan sponsors in complying with their fiduciary duty obligations in selecting annuity providers for plans and enable fiduciaries to rely on such assessments as a safe harbor." The report made clear that this "independent fiduciary function would not otherwise affect the fiduciaries' ERISA responsibilities to evaluate all other aspects of the annuity purchase decision" such as the price and other terms of the annuity contract.[81]

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[79] The guarantee limits are stated in terms roughly equivalent to annuity premium as opposed to annual annuity payment. Individuals seeking diversification of insurer solvency risk can of course divide their annuity purchase among multiple insurers.

[80] Commission on Retirement Security and Personal Savings (2016), p. 66. The Report stated that plan sponsors "should be able to look to others for guidance on the financial strength of the carrier." Ibid.

[81] U.S. Department of the Treasury (2017), p. 143. See also BlackRock (2018), BlackRock (2019); Reish and Ashton (2018).

2. Use of Financial Strength Ratings: Private- and Public-Sector Examples

Imperfect as they are, NRSRO financial strength ratings of insurers have long been and continue to be commonly relied upon in various contexts as a leading measure of claims paying ability. By way of illustration, the following are a number of examples—from the private and public sectors, including annuity quotation platforms, marketing materials, regulations, policy recommendations, and other sources—of how annuity providers' NRSRO ratings are used for this purpose.[82]

Fidelity Investments offers annuities provided by various insurers and by its own insurance subsidiary. See https://www.fidelity.com/annuities/deferred-fixed-income-annuities/compare When offering deferred income annuities provided by other insurance companies, Fidelity shows the financial strength ratings of each insurer from two different rating agencies -- AM Best and S&P -- and shows, as of this writing, that each such insurer is rated Superior (A++ or A+) by AM Best and Very Strong or Strong (AA+, AA-, or A+) by S&P.

Annuities.com advertises that it provides quotes "from A+ rated companies". See www.annuities.com

Immediateannuities.com encourages customers to "[m]aximize the safety of your annuity by learning which companies have the highest ratings."[83] See www.immediateannuities.com

Hueler Income Solutions annuity purchase and quotation platform is "a web-based lifetime income annuity purchase system" with an online platform stating that "multiple highly rated insurance companies compete on each quote" and showing customers each annuity provider's current financial strength ratings from three different rating agencies. As of this writing, all but one of the providers on the platform are rated A+ by A.M. Best, and the other one is rated A. See.https://www.incomesolutions.com/homepage.aspx

ERISA Counsel: Experienced, respected ERISA counsel have recommended that ERISA plan fiduciaries selecting insurers to provide annuities for plans take into account the insurers' financial strength ratings.[84] Moreover, in testimony before DoL's ERISA Advisory Council, ERISA counsel had this to say about the legislative safe harbor for selection of annuity providers that is pending in Congress:

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[82] These examples are in addition to DoL regulations and related guidance (including proposed prohibited transaction class exemption amendments) emphasizing the importance of taking into account NRSRO financial strength ratings in a fiduciary assessment of annuity providers' financial strength and claims paying ability, as well as the recommendations in the 2017 Treasury Department Report and 2016 Bipartisan Policy Commission Report (all discussed in section 1 of this Appendix). See also sections II.A, II.B.2, above.

[83] Similarly, Nerdwallet states that it does not recommend considering insurers unless they are sufficiently highly rated.

[84] Reish and Ashton (2017), pp. 35-36. Reish, Ashton, and Faucher (2012), pp. 12-13.

"We are concerned, though, about a safe harbor that has, as its foundational basis, a certificate of authority from the insurance commissioner of its domiciliary state. Unfortunately, the quality of State regulation and oversight varies. As a result, it is possible that an insurer could be domiciled in a state that does not have robust requirements and supervision of its insurance companies. That deficiency [could] be offset in a number of ways. For example, we list a number of factors in our white paper on evaluating in-plan guarantees. . . . However, if a safe harbor is created via legislation, information provided by rating agencies could be used. . . . In that case, one of the standards could be that the insurance company be rated by at least one of the major agencies as being financially strong and that none of the rating agencies have a financial strength rating below their designation of good financial health. . . . [T]he ratings should be viewed for both the most recent completed year and for the preceding five or 10 years. In other words, the safe harbor should require that the financial strength be maintained for over a full economic cycle. To meet the needs of plan sponsors, the criteria would need to be objective."[85]

Addressing, outside the context of a safe harbor, the "four main areas that fiduciaries should consider when evaluating an insurance company," the first two specified by these ERISA counsel are "financial strength of the company" and "evaluation by the rating agencies."[86] Stressing the important role that ratings play, they advise that,

"Since the capital adequacy, balance sheet strength, claims paying ability, and financial strength of an insurer are all analyzed and incorporated into the rating agencies assessment, one of the most important steps a plan sponsor can take is to understand the current ratings and ratings over recent past and to ensure the insurance company offering the retirement income product fully cooperates with the information requested by the rating agencies."

Counsel's discussion proceeds to describe and explain the separate rating categories and scales used by each of "the four major" ratings services, stating that "acceptable ratings for financially strong companies are considered" to be A or higher from A.M. Best, A- or higher from Fitch Ratings, A3 or higher from Moody's, and A- or higher from S&P. The discussion also summarizes approvingly and elaborates on DoL's statements (in its 2007 proposed regulations and preamble to its final 2008 regulations) regarding the importance of the rating agencies' insurer financial strength ratings, including the importance of taking into account any adverse comments or negative information the rating agencies might provide.

Michigan PERS Investment Legislation. Michigan's statutory guidelines for fiduciaries investing pension funds for plans covering state and local government employees have long authorized investment in annuity contracts if the annuity provider has "a claims-paying ability rating" of at least A from A.M. Best or AA- from Duff & Phelps (now Fitch) and an

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[85] Reish and Ashton (2018), pp. 5-6. The ERISA Advisory Council heard generally similar views about the desirability of including financial strength credit ratings in a statutory fiduciary safe harbor from one of the authors in his oral statement to the Council. In addition, BlackRock, Inc., in its written statement to the Council, stated that "[p]lans would benefit from guidance surrounding the steps they need to take to evaluate lifetime income solutions to meet safe harbor requirements. For example, **the safe harbor could look to the credit rating**, licensing, length of operations or size of a particular insurer." BlackRock (2018), p. 3 (emphasis added). See also BlackRock (2019), p.4.

[86] Reish and Ashton (2018).

overall company financial strength rating of at least Aa3 from Moody's or AA- from S&P. (The law also requires insurers to have been in operation for at least 5 years and to have specified minimum assets under management.)[87]

3. Scope of Insurer Selection Safe Harbor

The determination that a selected annuity provider is sufficiently strong financially to be a prudent choice is an issue that generally does not vary from plan to plan and accordingly is suitable for safe harbor treatment. By contrast, prudent ERISA fiduciaries should carefully examine and compare the costs and other specific terms of annuity contracts; and in many if not most cases, they should negotiate those terms. Therefore, a safe harbor from liability should not cover contract terms.[88]

While earlier drafts of proposed regulatory and legislative fiduciary safe harbors did extend beyond the selection of the insurer(s), more recent versions were for the most part generally limited to the financial strength of the insurance company. In some cases, however, the more recent safe harbors might have been read as also extending safe harbor treatment to the terms of the annuity contracts. After one of the authors of this paper raised this concern in the legislative process last year, ambiguous legislative language was partially, but not completely, revised to make clear that the safe harbor applies to the selection of the annuity provider, not selection or negotiation of the annuity contract terms.[89] The remaining ambiguous language should be clarified to confirm the limited scope, consistent with the relevant House Ways and Means Committee Report.[90]

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[87] See Michigan Compiled Laws (1965).

[88] Similarly, the Bipartisan Policy Commission 2016 report took the view that, while insurers' financial strength should be covered by an objective safe harbor because it is difficult for plan sponsors to assess on their own, it is reasonable to require plan sponsors "to carefully evaluate the appropriateness of particular investment and distribution options."

[89] Further clarification is important because regulators generally are conscientious in parsing every word of statutory language to ascertain congressional intent. Indeed, standards of statutory construction presume that language would not have been included without a reason. Accordingly, in a case such as this, careful clarification can help prevent "safe harbor mission creep" based on post hoc arguments that Congress intended generally to encourage certain activities and therefore the scope of the provision should be "read broadly" to permit related activities even if they do not unambiguously come within the scope of the safe harbor.

The language of the proposed legislative safe harbor suggesting that it covered not only selection of the annuity provider but also selection of the annuity contracts tracked language in the Labor Department DC plan regulation. However, the regulation (unlike the legislative safe harbor proposal) could fairly be said to extend to the selection of the annuity contracts because it expressly required fiduciaries to "appropriately" consider the costs of the contracts in relation to their benefits and "appropriately" conclude that those costs were reasonable. By contrast, nothing in the proposed legislative safe harbor's required representations from insurers regarding their good standing with state authorities bears on the costs or other terms of the annuity contracts. Accordingly, there is no sound basis for extending the proposed legislative safe harbor to the selection of the contracts.

[90] While a Joint Committee on Taxation summary of the proposed SECURE Act legislation approved by the House Ways and Means Committee incorrectly misstated the scope as including selection of the annuity contract, see Joint Committee on Taxation (2019) pp. 50-52, the House Ways and Means Committee Report on the SECURE Act, Committee on Ways and Means (2019) pp. 84-87, defines the narrow scope correctly.

Another potential ambiguity in the pending legislative safe harbor language relates to the cost standard. The proposed statutory safe harbor, when largely tracking the language of DoL's DC plan regulation, replaces the regulatory language requiring consideration of annuity contracts' costs "in relation to the benefits" under the contracts with language that refers instead, and more cryptically, to the "relative" costs of the contracts. This unnecessary ambiguity might conceivably be exploited by arguing in the future that, for example, Congress intended to require fiduciaries to consider the costs of a given contract only relative to the (potentially excessive) costs of other contracts in the market.

4. Coverage of Variable and Indexed in Addition to Fixed Income Annuities

The legislative safe harbor provision pending in Congress departs significantly from the scope of the DoL "safe harbor" regulation and other DoL guidance. The regulation refers to contracts for "benefit distributions," which could be read to be limited to income annuities, i.e., annuity contracts designed simply to distribute benefits in the form of a regular, predictable stream of income in retirement. This differs from accumulation-type annuities designed mainly or largely to serve as tax-favored investments, such as indexed or variable annuities (often supplemented by "guaranteed lifetime withdrawal benefits"). DoL's 2015 bulletin on annuities in ERISA plans also focused on "benefit distributions," and its examples were limited to fixed income annuities.[91] Essentially the same is true of Treasury's 2014 guidance on QLACs and its guidance on annuities embedded in target date funds.[92] By contrast, the term used in the currently proposed legislative safe harbor ("guaranteed retirement income contract") would broaden the scope to cover the selection of providers of variable and indexed annuities.

As noted, variable and indexed annuity products and associated sales practices have for years been criticized for undue complexity and lack of transparency that predictably confuse and mislead consumers while frustrating efforts to compare products and prices on an apples-to-apples basis. Relatedly, these products have long been taken to task for often excessive fees and commissions that can bias brokers in favor of the highest commission products and that are hard for consumers to identify and take into account.[93] Consumer advocates also maintain that most state insurance departments have not been effective in addressing these well-publicized problems, and that, for all of these reasons, a safe harbor for selection of annuity providers should be limited to providers that offer fixed income annuities.[94] Meanwhile, mutual funds and other financial services industries have complained that the insurance industry would be unfairly advantaged by a fiduciary safe harbor that covers the selection of insurers providing products that are called annuities but are overwhelmingly used to provide tax-deferred investment accumulation rather than guaranteed retirement income for life. A strong case can be made, therefore, for limiting the ERISA fiduciary safe harbor to insurers providing types of annuities that are designed mainly to provide guaranteed income in retirement (while continuing to permit plans to offer variable, indexed, or other accumulation-oriented types of annuities outside of the safe harbor if prudent and in participants' interests under normal ERISA fiduciary standards).

There are several policy arguments against limiting the safe harbor to fixed income annuities. First, variable and indexed annuities are not necessarily or invariably complex, nontransparent, or high-priced. Such products could be made far more understandable, transparent, comparable to competing products, and therefore more reasonably priced,

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[91] Employee Benefits Security Administration (2015).

[92] Internal Revenue Service (2014a, 2014b). See also discussion in Toth and Giller (2013).

[93] See, e.g. Backman (2018).

[94] Consumer Federation of America (2019).

although much in their history and reports of current practices give grounds for concern.[95] A fiduciary safe harbor that is justified based on annuities' distinctive capacity to protect retirees from longevity and market risk could still apply to the selection of insurers providing variable annuities that are designed to be consumer protective and mainly to provide guaranteed retirement income.[96]

Second, the industry would point out that excluding these products from the safe harbor would constrain market creativity in designing products responsive to consumers' needs (while consumer advocates would reply that the prevalent forms of creativity in the annuity market have too often involved complexity and obfuscation maximizing advisor compensation at consumers' expense). A third argument would contend that, because the scope of the safe harbor is limited to selection of the insurer, the design and terms of the annuity contracts would remain outside the safe harbor and hence subject to ERISA's full fiduciary analysis. Accordingly, plan sponsors' concerns about the risk of litigation and liability might also help make them sufficiently wary of complex, high-priced products.

In addition, while concerns about risks to consumers from variable annuities have focused on the retail market, the offering of annuities, including variable annuities, in ERISA plans might generally be expected to involve less inequality of bargaining power between the insurance industry and consumers and therefore more institutional rather than retail pricing. ERISA requires fees to be limited to a reasonable level, and its duties of prudence and loyalty obligate plan officials to represent participants' interests by competently seeking the best deal possible for them.

That said, even though ERISA's normal fiduciary duties (not the safe harbor) apply in determining the terms of the contract, this might matter less to medium-sized or smaller plans, as a practical matter, that are less likely to benefit from expert, specialized advice or representation than larger plans. There may still be a risk that the legal distinction – that the safe harbor applies to the selection of insurers offering variable and indexed annuities but not the selection of the terms of those annuities—will be blurred for smaller plans. The practical result might be that the fiduciary analysis of the type of contract and its terms would be colored by an overall sense that Congress, in the safe harbor, has in effect approved the use of variable and indexed annuities in ERISA-governed plans.

This is another reason some consumer advocates argue that the safe harbor for selection of insurers should be limited to apply only when insurers are offering fixed income annuities. The Consumer Federation of America has opined that "There are two characteristics of [variable and indexed] market-guaranty annuity products that require exclusion from the RESA safe harbor—an untested and evolving state regulatory framework and the consumer protection problems of high fees and misleading products."[97] A related argument for limiting the safe harbor is that the statutory exemption for indexed annuities precludes

. . .

[95]Like the question of whether a statutory ERISA fiduciary safe harbor should be subject to a quality standard based on insurers' financial strength and claims paying ability, the question of whether the safe harbor should be limited to insurers providing fixed income annuities has not been the subject of much attention in Congress.

[96] While a potentially helpful way to introduce annuities to DC plans is to embed them in a 401(k) plan's target date fund default investment (QDIA) as part of its fixed income asset class, this is different from using variable annuities that attempt to replicate much of the asset diversification of the target date fund or other QDIAs. Instead, a fixed income annuity could provide both guaranteed retirement income and fixed income asset exposure (which would otherwise commonly be provided by bonds). See, e.g., Internal Revenue Service (2014a) and Internal Revenue Service (2014b).

[97] Consumer Federation of America (2019).

the SEC from regulating those products and protecting consumers from what many describe as inappropriate and misleading marketing practices facilitated by complicated indexed annuity product designs.[98] Consumer advocates contend that "the new market-guaranty annuity products have posed a challenge for [state] insurance regulators, and the regulatory framework for such products is a work-in-progress"—including an ongoing multi-year NAIC project "to establish a capital and reserving framework for variable annuities." Implicit in this would be the possibility of limiting a current fiduciary safe harbor to the selection of insurers providing fixed income annuities but amending it later to include insurers providing indexed and variable products once an appropriate regulatory framework is in place and working adequately.

Finally, consumer advocates have maintained that state insurance departments have less experience regulating these evolving and rapidly expanding indexed and variable annuity products even from a solvency (not only a consumer protection) standpoint.[99] In the case of a fiduciary safe harbor that does apply to the selection of insurers providing indexed and variable annuities, this would be another reason to include a ratings-based financial strength standard as part of the safe harbor.[100]

5. Requiring Insurer Experience Providing Annuities

Annuity providers included in the safe harbor should be sufficiently experienced in providing annuities. The pending legislative safe harbor provision requires insurers to represent that they are licensed to provide annuities and have operated in accordance with a valid certificate of authority for at least seven years. We would make clear that this seven-year experience requirement means that the insurer or its organizational unit that provides annuities has been in the business of providing annuities for that period. (The pending legislative language is ambiguous on this point.)[101]

. . .

[98] See note 23, above.

[99] "[W]hile state insurance regulators have a long—and successful—track record regulating the solvency and consumer protection aspects of simple fixed annuities without accumulation features, the same cannot be said for annuities with accumulation features." Consumer Federation of America (2019).

[100] Consumer Federation of America (2019). The National Association of Insurance Commissioners (NAIC) has projects under way to develop further regulatory measures.

[101] See also Reish and Ashton (2017). Unfortunately, an experience requirement, like most other criteria in this area, is highly imperfect. Given the frequency of corporate transactions and changes in management, a given insurance company's years of experience will not always be meaningful, and it is more challenging and labor-intensive for regulators to assess experience at a smaller business unit or individual level. The process of developing financial strength ratings, however, might be better able to take such factors into account (in much the same way that analysts track management changes in mutual funds).

6. Should Risk-Based Capital Ratios Be an Element of the Safe Harbor?

Another potential metric would be the risk-based capital (RBC) ratios that state insurance departments approve or determine and take into account.[102] Insurers file annual statements reporting on their capital reserves, which are compared to a minimum RBC requirement that varies depending on the type of insurance and the kinds of risks to which an insurer is exposed. Those whose actual capital falls short of the minimum required amount must take or be subjected to certain preventive or remedial actions. RBC formulas and ratios were designed to provide early warning of problems, helping state regulators keep watch over particular companies' financial situations and identify any solvency issues or financial distress situations that call for regulatory intervention.

RBC ratios are described mainly as intended to help identify troubled insurers rather than to serve as a basis for drawing comparative distinctions between insurance companies based on their financial strength. That said, in a proposed safe harbor designed to rely on state regulators to determine insurance companies' financial strength and claims-paying ability, representations that merely address whether the insurer is the subject of unusual and dire regulatory intervention such as an order of supervision, rehabilitation, or liquidation is of limited utility to fiduciaries, especially in view of ERISA's exacting fiduciary standards. More helpful might be disclosure, as part of the insurer's representations to plan fiduciaries, of the insurer's state-approved RBC ratios (and related data). State regulators and rating agencies rely on RBC ratios (which are generally kept confidential) as one major factor in assessing financial strength and stability. However, before any such RBC ratio disclosure is required, we recommend that DoL (in consultation with Treasury, NAIC, the actuaries, insurance industry representatives, and other expert organizations) determine and advise on whether, and if so, how, disclosure of state-approved RBC ratios could be used or adapted to add value to a safe harbor, even if the safe harbor criteria were based on financial strength ratings and not also on RBC ratios. Pending the results of such an analysis, we would not recommend that RBC ratios be included in the safe harbor criteria because they already are taken into account by the NRSROs, together with other information, in formulating financial strength ratings, and because reportedly the ratios can be somewhat readily manipulated.[103] However, RBC ratios might, for example, inform analyses by plan sponsors that decide not to rely on a new fiduciary safe harbor but instead to select an annuity provider pursuant to ERISA's normal fiduciary standards, using financial strength determinations such as those prescribed by DoL's annuity selection regulations (as is generally done when selecting annuity providers for DB plans, where no safe harbor applies).

. . .

[102] State regulators also rely on NAIC's Insurance Regulatory Information System Ratio Results Reports, which, without attempting here to be precise, are generally intended to be included, to the extent applicable, in the references in the text to RBC ratios.

[103] Whether DoL should require annuity providers to disclose their RBC ratios if they wish to be considered for selection by DC or DB plans pursuant to DoL's regulations—without regard to the safe harbor—is a question not addressed here.

For NAIC-aggregated life RBC data, see www.naic.org/documents/research_stats_rbc_results_life.pdf?31 If a fiduciary safe harbor were to specify an RBC ratio threshold that annuity providers had to meet to be treated as highly qualified, insurers seeking that safe harbor designation could voluntarily disclose their RBC ratios (perhaps within appropriate ranges), which NAIC could verify.

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