The truth about institutional income annuities

More often than not, the word “annuity” raises concerns because of “conventional wisdom” that all annuities are costly, complicated, offer limited liquidity, and charge penalties when early withdrawals are taken. To a great extent, these misperceptions have taken hold among consumers generally as the result of variable annuity products being sold and used as investments.

Unfortunately, these generalizations about an entire product category paint an incomplete picture of the important role that income annuities — particularly institutional income annuities offered by employers in the qualified plan arena — can play in ensuring successful retirement outcomes for defined contribution (DC) plan participants. After all, “annuity” is a four-syllable, not four-letter, word.

Separating facts from perceptions is particularly important for plan sponsors who are contemplating DC plan design changes focused on improving retirement outcomes, such as offering income annuities to enable participants to secure guaranteed lifetime income.

This paper addresses the sometimes expressed, and often assumed, myths and misperceptions about annuities. For purposes of this paper, we will be focusing on a certain type of annuity, specifically, an institutional income annuity.

An institutional income annuity is a group annuity contract that provides an immediate fixed income that cannot be outlived... period.
Dispelling misperceptions about institutional income annuities

Misperception: As a DC plan sponsor, I don’t need to offer an income annuity because my participants aren’t asking for them.

Reality: Plan participants are interested in income annuities. In fact, four in five current DC participants express interest in putting some or all of their money in guaranteed lifetime income products.2

Unfortunately, since most DC plans were established as companion savings plans to complement or supplement defined benefit (DB) plans, plan sponsors have not been in the habit of thinking of retirement outcomes for DC plans until recently, as DB plans have been playing a smaller role in most retirees’ income plans. As a result, communications and expectations for DC plans have been based on an assumption that when retirement occurs, the plan ends, and participants need to withdraw their money as part of their retirement process. That said, even with a limited focus on retirement income-related issues, plan participants are interested in having their employer offer an income annuity.

Misperception: Income annuities are complex, confusing and difficult for participants to understand.

Reality: Compared to other types of annuities, income annuities are relatively simple to understand. Additionally, research has shown that the decision to annuitize is affected by the way the choice is framed.

Individuals are more than three times as likely to prefer a life annuity to a savings account when the choice is framed in consumption terms (i.e., what they could purchase with the income they receive), rather than in investment terms, which makes them seem complex and difficult to understand. According to authors of the research, “[W]hen consumers think in terms of consumption, they perceive the life annuity as offering valuable insurance against the risk of outliving one’s resources. However, when they think in investment terms, they view life annuities as increasing risk without increasing return, because of the potential for variation in the total value of payments based on how long they live.”3
Misperception: Income annuities are bad investments vis-à-vis other products.

Reality: An income annuity is an insurance product, and should not be considered an investment account, but a complement to other sources of retirement income, including Social Security.

While mutual funds and other investments play an essential role in retirement, as they provide liquidity and possible asset growth that can help offset inflation, the income that can be withdrawn from these investments can be unexpectedly reduced in a year when markets don’t do well, and will run out if one lives longer in retirement than anticipated. Annuities, on the other hand, are an insurance product that protects against these scenarios and guarantees that there will always be an income stream, regardless of market performance or life expectancy.

Misperception: Insurance companies charge high fees for income annuities.

Reality: Not so. Just like with other insurance products, insurance companies charge for the benefits that income annuities offer. Typical income annuity premiums are inclusive of all expenses, and should be assessed based on the income amount they generate, the payment options they provide at death and the strength of the carrier’s guarantee.

When considering an income annuity, a plan participant should compare the ability of an annuity to produce a given amount of income from a defined amount of premium to the ability that the same amount of funds, invested to maximize income, would produce, in addition to a liquidation of the principal over time. Such an exercise quickly and clearly illustrates the value the annuity provides. For example, even with a conservative investment in bonds, for each dollar the retiree shifts from bonds to immediate annuities, 56 cents is available for additional spending.⁴
Accounting for longevity risk also involves an individual making their income last for approximately 20–30 years in retirement, including potentially living longer than an average life expectancy. In fact, 79% of people aged 60 will live beyond age 80, and 46% of people aged 60 will live beyond age 90.\(^5\)

Unfortunately, when approaching retirement, many participants choose to take a lump sum payment from their DC plan because the amount is typically more money than they have likely saved in any other vehicle, and it is difficult for them to resist removing the money from the plan. This is called the “wealth effect.” They then try to draw down their savings throughout the rest of their lives, in essence self-insuring their retirement. However, self-insuring is a high-risk proposition, primarily because of the likelihood of depleting assets prematurely or under-spending for fear of running out of money. This is why enabling participants to secure lifetime income is essential.

Misperception: A systematic withdrawal program (SWiP) — or drawdown strategy — is just as effective as an income annuity for plan participants when they retire.

Reality: With a systematic withdrawal program (SWiP) — or drawdown strategy — individuals run the risk of running out of money in retirement due to longevity risk and market risk.

Very often when an employer-sponsored plan offers installments or systematic withdrawals, it utilizes IRS life expectancy tables to determine the level of income to be withdrawn. For example, if the participant’s life expectancy at retirement is 20 years, the installment benefit would equal the individual’s plan balance discounted by a stated interest rate for 20 years. Once the individual reaches his or her life expectancy the money — and the benefit — ends. Clearly, such an arrangement poses problems for those people who outlive their life expectancies. Should market performance not equal or exceed the withdrawal discount rate at all times, an individual could deplete his or her account balance after just a few years into retirement, or be forced to suspend or reduce current income in order to preserve an income source in the future. They might even be forced back into the workforce to supplement their incomes.
A SWiP approach can be more effective when it is used in combination with a guaranteed source of income, such as an immediate income annuity or a deferred income annuity — e.g., longevity insurance. The combination of a SWiP and guaranteed income can enable participants to both manage their retirement savings to a defined time horizon with assets that offer liquidity, and have the benefit of a steady, guaranteed income stream that they cannot outlive.

Partial annuitization is a critical design feature of a plan distribution option, since it allows plan participants to secure a level of guaranteed income and also withdraw, over time, the remaining assets in their retirement portfolio.

Misperception: Income annuities can only be purchased through an insurance agent.

Reality: While retail annuities can be purchased through an insurance agent, there are benefits to plan participants being able to purchase an income annuity through the workplace.

In fact, more employers are recognizing the value of offering income annuities to their employees as part of their qualified retirement plans. Insurance providers have developed income annuities that can serve as voluntary plan features with group pricing, or can be obtained by plan participants at retirement through various platform providers. By offering income annuities to DC plan participants, particularly at the point of retirement, plan sponsors can have the assurance that they have done everything possible to help participants generate an important source of guaranteed lifetime income.

If a qualified plan does not provide annuities in their plans or access to platform providers, and if a qualified plan balance is rolled over to an IRA, such “Rollover IRAs” can be set up as income annuities.

Misperception: It is too complicated to add an income annuity to a DC plan.

Reality: False. Adding an income annuity is similar to adding a new investment option to a DC plan.

It can be added to a DC plan in five simple steps:

1. Select the provider
2. Amend the plan
3. Notify plan participants and beneficiaries
4. Modify the summary plan description and the election benefit form
5. Establish procedures for administration and 5500 filing
**Misperception:** Fiduciary issues are too challenging for me to offer an income annuity to my DC plan.

**Reality:** The decision to add an income annuity feature, as with any plan design matter, is a settlor function, not a fiduciary one, so it carries no fiduciary burden.

Plan sponsors do, however, have a fiduciary responsibility for how each of the features in its plan design operates. In the case of an income annuity feature, this would focus on the carrier it selected as its provider. While safe harbors are neither an exclusive method for a fiduciary to satisfy ERISA’s standard of care, nor a minimum, fiduciaries generally seek a safe harbor when selecting plan providers and adding new plan features. The Department of Labor (DOL) issued regulations in 2008 to create a “safe harbor” for selecting an annuity provider for DC plans, and at the same time amended its Interpretive Bulletin 95-1, explicitly indicating that it did not apply to DC plans. Plan sponsors, other commenters, and the ERISA Advisory Council have consistently advocated since then for the DOL to amend the 2008 regulations and, in particular, the part of the safe harbor requiring that the fiduciary appropriately conclude that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract.

In FAB 2015-02 the DOL clarified a fiduciary’s responsibilities under the safe harbor regulations when selecting and monitoring an annuity provider. The FAB provides that a fiduciary’s prudent selection and monitoring of an annuity provider is judged based on the information available at the time of selection and at each periodic review, rather than on subsequent events. The fiduciary is also not required to review the appropriateness of its conclusions with respect to an annuity contract purchased for any specific participant or beneficiary. The FAB states that the periodic review requirement does not mean that a fiduciary must review the prudence of retaining an annuity provider each time a participant or beneficiary elects to receive a distribution in the form of an annuity from the selected annuity provider. It also clarified that the frequency of reviews depends on the facts and circumstances. For example, a fiduciary may have an obligation to conduct an immediate review if he or she knows that the annuity provider is not making annuity payments or that a major insurance rating service downgraded the annuity provider.

Additionally, the FAB clarified that a fiduciary’s monitoring responsibility ends when a plan stops offering annuities from the specific annuity provider. This could occur if a plan replaces an annuity provider or stops offering an annuity distribution option.
Furthermore, the FAB provided guidance in respect to the statute of limitations and provides that a fiduciary duty claim may not be brought after the earlier of (a six years after the date of the last action which constituted a part of the violation or, in the case of an omission, the latest date on which the fiduciary could have cured the violation, or (b three years after the earliest date on which the plaintiff had actual knowledge of the breach. The FAB states that a claim for imprudently selecting an annuity contract would have to be brought within six years of the date on which plan assets were used for the contract’s purchase and does not continue running while a participant receives annuity payments.

Generally, if a plan sponsor allows an annuity provider to make an income annuity available at retirement through a voluntary IRA rollover, and does not provide investment advice, endorse or sponsor the product or carrier, then the IRA should not be subject to the ERISA rules and the employer would not be deemed to be an ERISA fiduciary regarding the IRA rollover. As more plan participants reach retirement age, and as regulatory focus has increased on practices related to qualified plan rollovers to IRAs, regulators and many plan sponsors are taking a fresh look at how plan participation is and can be handled after retirement or separation from service.

Misperception: Annuities are only appropriate for workers who have saved a lot, or have saved too little.

Reality: Almost everyone with a retirement nest egg from a DC plan — large or small — should consider purchasing an income annuity with a portion of their assets. The best time for a participant to annuitize is when their paycheck stops and they need a guaranteed monthly stream of income.

During one’s working career, nearly all financial decisions (e.g., where to live, how much to spend, what job to take, etc.) are based on how much income one earns. Therefore, it only makes sense that an individual would want to create a retirement “paycheck” for when they are no longer working. With its regular stream of payments, an annuity can facilitate the transition into retirement, as well as a participant’s mindset from accumulation to income.

However, there are certain individuals who should generally not purchase an annuity, particularly those individuals who are very ill, have very low income, or who are extremely wealthy and do not need the protection provided by a guaranteed stream of income.
Misperception: If a participant buys an annuity and then dies, the insurance company keeps their money.

Reality: If a retiree is interested in leaving a legacy, most annuities have benefit options to provide continuing payments when they die. These include, as examples, continued payments for the life of a spouse or guarantee periods that ensure heirs will get the remaining income payments for a minimum period.

Income annuities make it possible for participants to shift various risks such as longevity risk, interest rate risk and market risk to an insurance company at the point of retirement. An insurance company is much better positioned to manage these risks because it does so for a large pool of people instead of a single individual. When the risks for a large group of retirees are pooled together, money that is left over from people who die earlier than the average life expectancy is used to continue to pay people who outlive the average age. As a result, monumental efficiencies become possible.

Misperception: A participant needs to use all of their savings to purchase an annuity.

Reality: Many individuals should consider purchasing an income annuity with only a portion of their retirement savings. One way to determine how much should be allocated to the purchase of an annuity is for the individual to first estimate their sources of income after they retire — usually Social Security and other pension income, if any — and their level of expected expenses during retirement.

Retirement income sources should be categorized by those that are guaranteed (e.g., Social Security and a DB pension) and those that are investment-related (e.g., mutual funds, stocks and bonds, etc.). Expenses should be classified in a similar manner between those that are essential (e.g., housing expenses, insurance, etc.) and those that are discretionary (e.g., travel, entertainment, gifts, etc.). An annuity should be considered to fill any gap that exists between the level of essential expenses and the amount of income being generated from the guaranteed sources like Social Security and DB pensions.
Reality: Income annuities create a predictable cash flow that actually enables individuals to have greater control over their finances.

One of the key advantages of income annuities is that they generally have the ability to produce the highest level of guaranteed income per dollar of assets, which provides the participant with the ability to maximize their retirement income. Again, income annuities from an insurance company are the product solution that provides control over longevity, inflation and market risk — risks that are impossible to predict and very costly to cover alone.

Please contact your MetLife representative or call 1-877-638-2862 if you would like to discuss these ideas in greater depth.
“Immediate” means that income payments begin within 12 months of election or purchase.


Society of Actuaries Annuity 2000 Mortality Table with 100% AA projection to 2016 and 150% projection thereafter, with mortality blended 50% Male and 50% Female at age 60.

Prior to the Pension Protection Act’s passage in 2006, the Department of Labor had published Interpretive Bulletin 95-1 which focused on carrier selection for DB plans, and Advisory Opinion 2002-14A, which indicated that IB 95-1 applied equally to DB and DC plans. These guidelines include factors such as size of the insurance company and financial ratings in addition to cost of the annuities. In 2006, the PPA directed the DOL to provide regulations specifically for DC plans, and to clarify that DC plans are not subject to the standard outlined in IB 95-1.


On August 19th, 20th and 21st, 2014, industry representatives testified before the U.S. Department of Labor’s (DOL’s) ERISA Advisory Council (EAC) on the Council’s three 2014 discussion topics, including facilitation of lifetime plan participation. MetLife’s Cynthia Mallett testified on behalf of the American Council of Life Insurers (ACLI) that the goal of lifetime participation is to prevent leakage from the retirement plan system overall and that rules must retain flexibility, facilitate educated participant choices, and not constrain their options. She expressed the ACLI’s view that employers should be encouraged to assist participants in making informed decisions by educating departing employees about their options, including providing materials that inform participants about their “future retirement income needs” as encouraged by existing DOL guidance. She also advocated that the DOL expand their guidance to specifically address providing information on distribution options, including lifetime income options.

In March 2013, the U.S. Government Accountability Office (GAO) released its report, “401(K) Plans: Labor and IRS Could Improve the Rollover Process for Participants,” which is based on research the GAO conducted to learn about the challenges that plan participants who are separating from service face regarding (1) implementing rollovers, (2) attaining clear information about which option to choose, and (3) understanding distribution options. The request for this research was made by Senator Tom Harkin (D-IA), chairman of the Senate Committee on Health, Education, Labor and Pensions, Senator Bill Nelson (D-FL), chairman of the Senate Special Committee on Aging, and Representative George Miller (D-CA), ranking Democrat on the House of Representatives Education and the Workforce Committee. The GAO found that the present rollover process “favors distributions” to individual retirement accounts (IRAs) versus rolling the funds into another employer plan due to “waiting periods to roll into a new employer plan, complex verification procedures to ensure savings are tax-qualified, wide divergence in plans’ paperwork, and inefficient practices for processing rollovers.”

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