Understanding How Guarantee Fees are Structured and Paid in Institutional Retirement Income Products

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Introduction

As the baby boomer workforce continues to head towards and enter into their retirement years, new products continue to emerge that go beyond the purpose of simply helping workers accumulate retirement wealth. Many of these products now entering the institutional retirement plan market include income guarantees. These income guarantees offer participants a way to insure that their retirement income will never run out. Although products for guaranteeing income are offered in the retail environment as well, this paper will address only institutional products offered through company-sponsored retirement plans. The purpose of this paper is to serve as a primer as to how participants pay for the additional benefits provided by these income guarantees.

Background

In the institutional market, income guarantees available to retirement plan participants generally take either one of two forms. The first type is the income annuity product. For the purposes of this paper, we will focus on the fixed income annuity product. The second form is a retirement income benefit known as a guaranteed minimum withdrawal benefit (GMWB) or guaranteed lifetime withdrawal benefit. The guaranteed minimum withdrawal benefit was developed by insurers to address what they perceive the market to need – flexibility and control at the participant level. This new wave of products represents a change in the way benefits can be offered, guaranteeing income benefits while allowing participants the flexibility to withdraw cash from the contract before and after retirement.

To provide an income guarantee and the services that go with it (such as direct deposit, investment management, customer service, etc), insurers will charge the participant a fee. The fee also covers the risk charge, capital reserve requirements, and anticipated profit of the insurance company. Fees for income guarantees vary by product type (and provider) and by the nature of features offered by the product. Some fees are explicit and easy to detect and are disclosed in the product information. Other types of products may have more implicit fees. Let's look at fees on both types of products.

The Income Annuity

There are two basic types of income annuities, immediate and deferred. The immediate annuity is designed for the worker retiring right away as payments must start within a year. The premium for an immediate annuity is paid as a one-time lump sum. This might be done as a plan distribution (if the plan allows it) or as a purchase within an IRA. In the latter case, the participant retires, takes a lump sum distribution from his retirement plan, and purchases an immediate annuity within an IRA. The deferred income annuity is purchased over time, usually within the plan as an investment option. The deferred income annuity typically provides liquidity until the point of retirement, where it becomes fully annuitized and illiquid. In other words, the deferred annuity becomes an immediate annuity at the point of retirement. The illiquidity is not all bad since income annuities can therefore pay a higher amount of guaranteed lifetime income than other forms of income guarantee products.

Fees in income annuity products available in the market can be difficult to determine for the annuitant. The reason is that, at the point of retirement for a fixed income annuity, the insurer only has one opportunity to charge for all future expenses that will occur. In other words, the account cannot have fees withdrawn over time since the income benefit remains constant and cannot be reduced by fees. As such, the fees are built into the pricing of the underlying product and are reflected in the monthly income benefit that is provided. Therefore the cost of both the income guarantee and investment management provided are considered implicit. An example of this is the monthly income benefit provided by the traditional fixed immediate annuity product. The benefit provides an income of $1000 (or some other amount) monthly for the life of the retiring worker. All else being the same, an income annuity with higher implicit fees would provide a lower monthly benefit than the same product that has higher fees built into the pricing.

The Guaranteed Minimum Withdrawal Benefit

The guaranteed minimum withdrawal benefit provides guaranteed lifetime income along with an underlying investment, such as a mutual fund. The lifetime guarantee of a minimum annual payment amount will be provided should the underlying investment run out. There is a fee for the investment management of the funds as well as a fee to fund the guarantee of benefits by the insurance company. The guarantee fee is charged by the insurer to provide for the risk charge, hedging costs, expenses in providing the future income, reserve costs, and the anticipated profit. Both types of fees are explicit and must be disclosed in materials made available to the participant. The fees are generally expressed as a percentage of the assets in the fund or a percentage of the income base (defined below).

With the GMWB products, the underlying investment is typically a target-date fund, a target-risk fund, or a balanced fund. Products are either passively managed or actively managed. Passively managed mutual funds will generally reflect a lower investment management fee than an actively managed mutual fund. Investment management fees usually will increase as the allocation to equities increases. Fees can vary from 16 basis points to 106 basis points on the investment management fee of institutional GMWBs.

Although the guarantee fee is also explicitly stated, comparing these costs between different products is not as easy as it is for the investment management fee. This is because the richness of the income guarantees can vary significantly between products. For instance, the minimum guaranteed income amount provided by the insurer will be based on a benefit base (also known as an income base). Under different GMWB products, that benefit base can increase annually based on a high-water mark (also known as a step-up), by a stated fixed percentage (such as 3%, also referred to as a roll-up rate), or not at all. In addition, some GMWBs will allow step-ups on the guaranteed withdrawal amount after payments start, whereas others don't. These are but two examples reflecting how income guarantees can vary between GMWB products. Note that other factors can also impact the level of fees being charged.

As a result, the value of the income guarantee should not be measured by the cost (guarantee fee) alone but rather what the participant is receiving in return for the guarantee fee. Contract features vary by contract and allow plans to determine the best product fit based on a combination of contract features and price. The cost of the guarantee varies between 0.50% and 1.40% depending primarily on the richness of the benefit. These fees are considered "current fees", contracts also allow some flexibility for the insurer to increase fees if necessary but no higher than the guaranteed maximum fee in the contract.

The following table identifies four fee structures on GMWB products available in the market today. The information is based on product information obtained from the providers and is available in the Product Fact Sheet section of the Institutional Retirement Income Council (IRIC) website at:

http://iricouncil.org/facts.

	Income Guarantee Fee	Investment Management Fee	Overall Fee
Prudential	1.00%	0.59%-.94%	1.59%-1.94%
Great West	0.90%	0.57%-.84%	1.47%-1.74%
Diversified	1.45%	0.16%-.19%	1.61%-1.64%
John Hancock	0.50%	0.91% - 1.06%	1.41%-1.56%

Conclusion

If plan sponsors wish to explore adding a retirement income product to their plan, it is important to understand what the participant will be paying and what value is being received. Income annuities can provide higher amounts of guaranteed lifetime income but the fees are not explicitly stated. GMWBs generally provide lower amounts of guaranteed income but provide for greater flexibility. GMWBs have explicit fees for both investment management and income guarantees, whereas fees are implicit on fixed income annuity products. Plan consultants and advisors can assist their clients to understand the trade-offs with each approach and each product candidate. The Institutional Retirement Income Council website provides additional tools to aid in this effort.

Institutional Retirement Income Council (IRIC)

As the burden of funding retirement has shifted from employer to employee, defined contribution plans, such as 401(k)s, have become the primary source of retirement savings for an increasing number of Americans. Yet DC plans were originally designed as supplemental retirement savings vehicles and were generally never intended to provide guarantee lifetime income.

The mission of the Institutional Retirement Income Council (IRIC®) is to facilitate the culture shift of defined contribution plans from supplemental savings programs to programs that provide retirement security. By providing a forum for insightful, solutions-oriented thought leadership on institutional retirement income, IRIC is promoting the need for retirement income adequacy for defined contribution plan participants.

A membership-based organization, IRIC is supported by sponsors, and a panel of industry advisors, who are dedicated to sharing best practices, informing about legislative and regulatory issues and facilitating solutions for plan sponsors and their participants.

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