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Feature: **A Bad Marriage? Variable Annuities and 401(k) Plans**

A Bad Marriage? Variable Annuities and 401(k) Plans

There is a raging debate about using variable annuities in 401(k) plans. To the insurance industry, it's a great idea; to critics, it's an outright scam.

By Margaret E. Haering

There is a raging debate over placing variable annuities in 401(k) plans. To the insurance industry, it's a great idea; to critics, it's an outright scam. The NASD and the SEC have warned against the practice. Some insurance industry leaders have paid millions to settle class actions claiming that the sale of variable annuities to qualified plans is unethical and deceptive.

Despite the controversy, variable annuity sales are booming. In 2004, variable annuity sales totaled $129 billion. Sixty percent of them were sold to qualified plans. The prevailing view is that variable annuities are not so much bought as "sold." Variable annuities are not a good choice for 401(k) plans. Plan sponsors need to be armed with the facts so they can resist the temptation to fall for an aggressive sales pitch. Otherwise, they could be in for a long, expensive relationship.

Variable Annuity Basics

A variable annuity is a mixed securities/insurance product, whose value fluctuates depending on the performance of mutual funds and investments chosen by the owner. During the savings, or "accumulation," phase, investments grow tax-free. At retirement, the owner can "annuitize" the accumulated funds to receive a stream of payments for a guaranteed period, like 20 years, or until death. When the money is withdrawn, the investment gains are taxed as ordinary income.

Variable annuities provide a death benefit, which guarantees that if the purchaser dies before retirement his beneficiaries will receive the original investment or accumulated value, whichever is greater. An insurance policy covers the guaranteed death benefit plus the rates of return and expense ratios that will be used in calculating future annuity payments.

When variable annuities are offered in 401(k) plans, an insurer issues a group annuity policy and provides administrative services. Participants invest their funds in a selection of sub-accounts or mutual funds.

What's the Problem?

There are a number of reasons why variable annuities are a bad idea for qualified plans. First, 401(k) plans already provide participants with a way to invest tax-free for retirement; any tax benefits that variable annuities offer are completely worthless to them. Critics cite these worthless tax benefits as proof that variable annuity sellers are more interested in a sale than in making investment recommendations that are suitable for qualified plans.

Second, most variable annuities are expensive. When 401(k) plan participants invest in the

average mutual fund, they pay about 1.4 percent a year for investment management plus transaction fees. With variable annuities, they are charged another 1.25 percent to 1.6 percent mortality and expense fee on top of mutual fund expenses. These embedded costs of 2.5 percent to 3 percent a year make it far more difficult for participants to get a decent return on their investments.

Third, some insurers promote their own mutual funds or investment accounts in variable annuity plans. This creates another income stream for insurance companies or their affiliates, but often leads to lackluster investment performance for participants.

Fourth, although the insurance industry touts the death benefit as a way of protecting principal, this coverage is infrequently used and carries a high price tag. The only way a plan participant can enjoy the insurance benefit is by dying with an account balance that is less than his original contributions, minus any withdrawals. The fact that domestic equities have historically grown by about 10 percent a year since 1925 makes it unlikely that a participant's account would fall below the original investment.

Behind the Hard Sell

Those who sell variable annuities are handsomely rewarded for their efforts. Insurance companies pay commissions that range from 5 percent to 9 percent of invested assets. These commissions, plus the value of assets now held in defined-contribution plans, help explain the aggressive marketing of variable annuities to qualified plans. Insurance companies discourage termination of variable annuity contracts by imposing surrender charges to make sure they can recover their sales expenses. Surrender charges may range from 5 percent to 7 percent in the first year and then decline by 1 percent a year. Until they disappear, termination of a variable annuity contract will come at a heavy cost.

Fiduciary Responsibilities

ERISA requires that a fiduciary act as a well-informed, prudent expert would when making decisions that affect the plan's investments or expenses. Obligated to act in the best interest of the participants, they must independently investigate the merits of any proposed investment. They need to understand fees charged and can only use plan assets to pay fees that are reasonable. Fiduciaries who neglect these duties can be held accountable if they cause the plan to lose money.

The Department of Labor, which oversees ERISA, recognizes that variable annuities are being used in retirement plans and has not taken a position on the issue. However, the selection of a variable annuity for a qualified plan poses special risks for fiduciaries. Here are some of those risks and the requirements that should influence the decision-making process.

Analyzing the Proposal

Before succumbing to an agent's enthusiastic recommendation of a variable annuity for a 401 (k) plan, the fiduciary should understand:

- What a variable annuity is.
- Whether the product provides benefits that are suited to the needs of plan participants.
- What fees are associated with the product.
- Why the fees are "reasonable."
- Whether there are surrender charges that will make it expensive to terminate the contract.

Obviously, someone who does not know the answers to these those questions will have no basis for demonstrating, if his judgment is ever challenged, why a variable annuity was a sound choice for the plan.

A good place to investigate variable annuities is the SEC's Web site. The SEC cautions that a variable annuity should be considered for a 401(k) plan "only if it makes sense because of the annuity's other features, such as lifetime income payments and death benefit."

However, it would be hard to conclude that the other features mentioned by the SEC make sense for the typical 401(k) plan. Although the availability of lifetime income is touted as the primary benefit of a variable annuity, industry statistics indicate that less than 5 percent of all variable annuity contracts take advantage of that feature.

A plan sponsor that wants to offer a lifetime income option could do so at lower cost by providing retiring employees with information on purchasing an immediate fixed annuity. That would save the remaining participants from paying yearly 1.25 percent mortality and expense fees to insure benefits they are unlikely to use.

A plan sponsor considering variable annuities should also question whether the expense associated with providing the death benefit is a good value. For example, if a participant contributed $50,000 to his 401(k) and died before retirement with a balance of $45,000, his heirs would receive the account balance plus $5,000 in insurance. To obtain that $5,000 protection, the participant would have paid a 1.25 percent mortality and expense risk fee on the entire $50,000, or $625 every year. Over a five-year period, death benefit coverage on that $50,000 account balance would cost $3,125.

In 2001, researchers at York University in Canada and Goldman Sachs compared the cost of purchasing term insurance with the expense of obtaining variable annuity death benefits. They estimated that the cost of providing death benefit coverage to policyholders was less than 10 percent of the mortality and expense risk charges that insurers collected annually.

Breaking Up Is Hard to Do

Finally, a plan sponsor has to be aware of surrender charges, which make it expensive to end the relationship if fiduciaries become dissatisfied with the investment performance or expenses. Surrender fees may also present a problem when a plan has to be terminated because of a merger or acquisition.

401(k) plans that terminate a variable annuity contract during the surrender period have essentially three choices: have the plan sponsor pay the fee directly; have the fee deducted from participants' accounts; or allow a new investment provider to pay the fee in exchange for increasing future expenses to participants. The first choice is merely painful. The second and third choices raise the specter of fiduciary liability. Although some plans have begun to challenge collection of surrender charges by insurers, many others just suffer in silence as they wait out the surrender period.

Just Say No

The bottom line is simple: When suitors come calling with a variable annuity policy for your 401(k) plan, there are many good reasons to resist taking the plunge. Like a bad marriage, variable annuities may last longer than you want and could be expensive to end.

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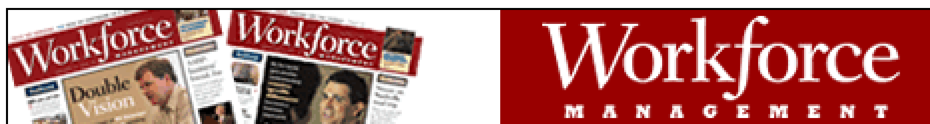

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