Regulating Markets for Retirement Payouts: Solvency, Supervision and Credibility

Or:
Like Taking Candy From a Baby (Boomer)

The Pension Research Council
April 23, 2007

Presented by

Martha Priddy Patterson
Deloitte Consulting

And

Phyllis C. Borzi
O'Donoghue & O'Donoghue LLP
and
Research Professor
Department of Health Policy
School of Public Health and Health Services
The George Washington University Medical Center

Demographics of Retirement Payouts

- Large cohort of baby-boomers (1946-1952) retiring
- The oldest boomers retirement -- at 55 in 2001, at 60 in 2006, at 65 in 2011; more will follow for the next six years
- Many, especially those retiring in 2006 and later, will be dependent on 401(k) payouts as their primary retirement income (other than Social Security)
- Most 401(k) distributions (and growing number of DB payouts) will be lump sums

Nature of the Problem

“Those people are
warm meat for crooks.”

- State securities officer describing the workers near retirement and retirees, in an interview with author, March, 2007 (Name omitted to protect the candid – and colorful)

Existing Insurance Against Many Risks Disappears at Retirement

Common Working Life Insurances Against Risk

- Wages generally offer some inflation insurance
- Health insurance
- Disability Insurance
- Life insurance
- Recurring income mitigates investment risk

Retirement Insurances Against Risk Limited

- Inflation
- Illness
- Disability
- Longevity
- Investment Risk -- Financial Solvency
- Limited opportunities to earn additional income

Existing Hedges Against Retirement Risks in Retreat

- Existing hedges against retirement risks are uncertain
- Many believe U.S. cannot sustain Social Security retirement and Medicare benefits for coming retirees
- Traditional defined benefit plans dwindling
  - terminated or frozen
  - closed to new entrants
  - conversions to cash balance plans

Dimension of Fraud Threat to Retirees

- Thieves go "...where the money is"
- For many boomer retirees their primary assets for retirement will be their defined contribution accounts (401(k), 403(b)s, ESOPs, Federal Employees Retirement accounts)
- Current average 401(k) balance for boomers
  - Just under $128,000 at 50
  - Just under $141,000 at 60
- This distribution often represents the largest single sum of money that an individual has had to manage

Information Gathering

Government Officials

- Sent written questions to state securities officials in all 50 states
- Sent written questions to insurance officials in top most populous 15 states
- U.S. Securities & Exchange Commission – Enforcement

Financial Advisers

Product Providers

- Interviewed product providers
  - Insurance providers
  - Securities/mutual funds

Public Interest Groups

- Investor Protection Trust
- AARP
- WISER
- ICI
- Trade association representatives

Protections Against Risk of Fraud and Insolvency of Retirement Products

- Regulation of Various Categories of Investment Products
  - Federal, State, and Self-Regulatory Organizations (SROs)
- Criminal law enforcement
- Financial education
- Publicity

Most Common Types of Retirement Investments

- Mutual Funds
- Insurance Company Products
- Bank Products
- Self-Directed Brokerage Accounts

Mutual Funds

- Investment company that pools money for investment in stocks, bonds, short-term money-market instruments and other instruments
- Organized under state law as corporations or business trusts, mutual funds are subject to both state and Federal law

Mutual Funds, cont.

- Applicable Federal laws
  - Investment Company Act of 1940 – regulates fund governance and structure
  - Securities Act of 1933 – requires SEC registration of publicly traded fund shares and regulates advertising
  - Securities Exchange Act of 1934 – regulates how funds are sold and requires those executing trades or distributing funds to be registered with the SEC as broker-dealers
  - Investment Advisors Act of 1940 – requires mutual fund investment advisors to be registered with the SEC, imposes reporting requirements and prohibits fraudulent, deceptive or manipulative practices

Mutual Funds, cont.

- Mutual funds are also subject to state securities regulation in those states in which the mutual fund sells shares
- NOTE: The National Securities Markets Improvement Act of 1996 (NSMIA) limited state regulation for mutual funds registered under the 1940 Act only to notice requirements, while establishing exclusive federal jurisdiction for other types of regulation

Insurance Company Products

- Typical insurance company products include guaranteed investment contracts (GICs) and fixed and variable annuities
- Regulation of insurance has long been the exclusive province of the states (McCarren-Ferguson Act), but dual regulation exists for variable annuity contracts
- Congressional proposals would create an optional federal charter for insurance and would allow insurance products to be sold nationwide, but both are controversial

Insurance Products, cont.

- Variable annuity contracts are generally subject to federal securities laws, including antifraud requirements
  - But they may be exempt from registration under the 1933 Act if offered in connection with a qualified plan
- Although treated as securities under Federal law, variable annuities may be classified as a security or an insurance product (or both) under state law
- This causes even more confusion
  - Recent study found only 14 states classify variable annuity contracts as securities
  - Presumably abuses regarding marketing and sale of these products would be handled by state insurance departments if not classified as a security under state law
  - But in 40 states, insurance department is given exclusive authority over variable annuities, even where state securities law treats them as securities, creating potentially overlapping state regulation

Insurance Products, cont.

- State Guaranty Association Coverage
  - Created by state law in all states covering life and health insurance; coverage varies by state
  - Protects policyholders against insolvency of insurance companies
  - However, since these guaranty associations are not state agencies, there is no state guarantee that all policyholders will be paid in full
  - When an insurer is insolvent, the guaranty association assesses member insurers a share of the amount required to meet the claims of resident policyholders; the assessment is based on amount of premiums within the state collected by member insurer for the particular type of insurance

Insurance Products, cont.

- State Guaranty Association Coverage
  - Usually individual and group life and health policies are covered as well as individual annuities
  - But coverage does not generally include any portion of a policy in which the investment risk is borne by an individual (e.g., variable annuity)
  - GIC coverage varies from state to state; currently 30 states provide coverage for GICs

Bank Products

- Generally bank investment products are regulated by the Federal banking agencies
  - The Federal Reserve Board
  - The Treasury Department's Office of the Comptroller of the Currency (OCC)
  - The Federal Deposit Insurance Corporation (FDIC)
- Goals of banking regulation:
  - To maintain the safety and soundness of the bank; and
  - To protect the interests of trust customers

Bank Products, cont.

- About half of all fiduciary assets held by trust institutions are held in retirement accounts (including IRAs and Keoghs)
- OCC supervises trust activities of national banks
- Federal Reserve and FDIC supervise state banks' trust activities
- Federal Reserve also supervises trust company subsidiaries of bank holding companies

Bank Products, cont.

- Typical bank products
  - Collective investment funds – OCC regulations allow national banks to pool investment assets of retirement plans and other large institutional investors into collective investment funds and operate those funds under fiduciary rules similar to ERISA (including prohibitions against self-dealing and conflicts of interest)
  - Bank investment contracts (BICs) are stable-value investment products that guarantee principal and interest for a fixed term
    - If considered a "deposit," they are insured by the FDIC
    - Similar to GICs but without annuity provisions

Self-Directed Brokerage Accounts

- Only offered by a relatively small number of plans, these accounts allow participants to invest in individual stocks and bonds in addition to mutual funds
- Participants open an account with a brokerage firm (either of their own choosing or one of several specified by the plan) and work with a broker-dealer
- These arrangements subject to Federal and state regulation as well as oversight by self-regulatory organizations (SROs)

Self-Directed Brokerage Accounts, cont.

- Broker-dealers are regulated by the SEC
  - 1934 Act requires registration with the SEC if an individual will be involved in transactions to “induce or attempt to induce the purchase or sale of any security”; also subject to antifraud provisions
- Broker-dealers are also subject to state securities law (including registration and antifraud requirements) in any states in which they do business

Self-Directed Brokerage Accounts, cont.

- The Securities Investor Protection Act of 1970 created the Securities Investor Protection Corporation (SIPC), a private nonprofit corporation to protect investors from losses resulting from the financial failure of broker-dealers
  - Most broker-dealers registered under the 1934 Act must become members of the SIPC; however broker-dealers who deal exclusively in distribution of shares of mutual funds or sales of variable annuities are exempt
  - Problem: while shares of mutual funds are covered under the SIPC, broker-dealers that deal exclusively in mutual funds are not members, and so their customers are not protected from insolvency losses

Self-Directed Brokerage Accounts, cont.

- Broker-dealers must also become members of another SRO – the National Association of Securities Dealers (NASD)
  - “suitability” obligation – before making any recommendation for purchase, sale or exchange of a security or executing the transaction, a broker-dealer must make reasonable efforts to assess whether the transaction is suitable for that investor given the customer’s financial and tax status and investment objectives

Bottom Line on Legal Framework

- Legal and regulatory framework complex and intimidating for consumers to navigate
- Overall retirees who invest their lump sum distributions will likely choose between two primary investment products: insurance or securities
- Some retirees will invest in both
- Each poses its own risks and has its own rewards
- Very different regulatory schemes

Bottom Line, cont.

- Insurance:
  - Guarantees typically available; but often lower investment returns
  - State regulatory structure, usually one locus: state insurance department
- Securities:
  - No guarantees, so riskier; but potential for higher investment return
  - Regulatory structure more complicated; harder for consumer to figure out where to go if a problem occurs
    - Federal, state, SROs
- Disputes over whether new products should be regulated as insurance or securities are becoming more frequent and the consequences of that decision are significant for consumers

Bottom Line, cont.

- Although many layers of regulation exist, unclear how effective they are in protecting individuals from loss in the first instance or in assuring prompt and full compensation for loss when it occurs
  - How useful is the right to sue for securities fraud for Enron retirees?
  - How useful is the reimbursement structure of state guarantee funds?

Bottom Line, cont.

- Most of current regulation focuses on public disclosure and registration with the government
  - How meaningful and understandable is that disclosure?
  - Are these activities as effective and visible enforcement tools as more traditional enforcement activity through government audits and monitoring activities?
  - Do they have sufficient deterrent effect?

Financial Education/Literacy

- In a system that relies so heavily on disclosure of financial information, financial literacy is critical
- All interviewees thought financial education/literacy information was important
- Most thought it was not effective, or not as effective as it should be
- Too little, too late

New Products –
Potential to Mitigate Some Risks

- Income Solutions®
  - Available only to employees of plan sponsors who contract with Income Solutions
  - Offers a platform that in effect is supermarket of annuity providers who compete to offer retiring plan participants annuities by “bidding”
- ELM Income Group of Washington
  - Outgrowth of project undertaken by a number of employers to use their market clout to encourage the widespread availability of an affordable annuity product for retirees
  - Structured as an individual, not group, product
  - Issuers must agree to offer the same annuity product to the public through the internet and via toll-free telephone staffed by salaried customer service representatives.

“Not Much Time to Get This Right”

- To paraphrase a number of regulators and public interest representatives. . .
- Need to “sell” financial literacy
- Need increased publicity
- Regulation primarily around disclosure to consumers may not be sufficient
- Continued strong – and visible – enforcement by state and federal regulators necessary
- Encourage adoption of financial products for retirement payout to hedge against retirement risks
  - May require streamlining some regulatory barriers
  - Tension of caution vs. encouraging those products/investments