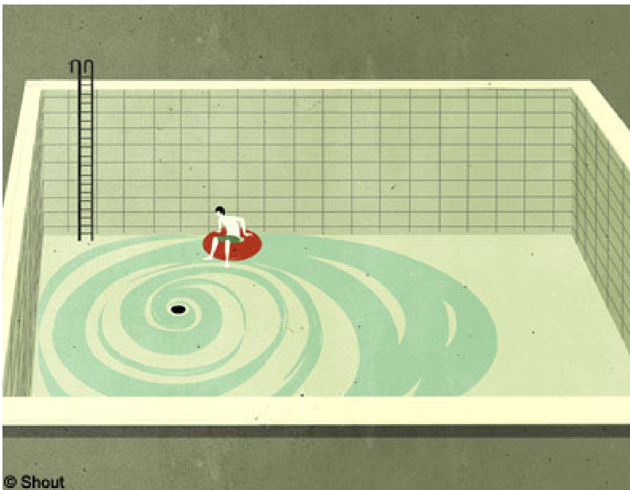
Forbes.com

Scott Woolley, 06.24.09, 06:00 PM EDT
Forbes Magazine dated July 13, 2009

Retirement Plans From Hell

Insurance salesmen have stuffed thousands of 401(k) plans into high-cost "group annuities."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Early this year the woman overseeing the 401(k) plan for a rural Oregon company gathered her 25 colleagues together to hold an election. At stake: whether to continue paying AIG an annual 1.25% of assets to manage their 401(k) plan as part of an insurance contract, or switch to mutual funds costing a third less. No surprise that the proposal to convert passed easily.

Then the nasty surprises started popping up. As she sought to unwind the plan, the administrator discovered that AIG had been tacking on a variety of fees all along. One nicked employees for 2% annually when they borrowed money from their own 401(k)s--work the new plan was willing to do for a flat $50 a year.

To top it off, AIG said that many of the employees would have to wait five years to get back their entire nest eggs, with no choice but to keep paying the fees. AIG says such lockups are disclosed in its plan contracts and are shorter than the ones many other insurers impose.

The company's frustrated administrator, who agreed to talk only anonymously, says she's still baffled by the complex annuity contract. "We still don't have a good handle on what they're charging us," she says.

Like the Oregon outfit, lots of mostly small companies are finding out the hard way that the 401(k) plans they bought from insurance companies, usually set up as "group annuities," came with a variety of hard-to-find charges and lockups. Or, more aptly, the plans they were *sold* by people motivated by lavish commissions. Many hyped the product as a low- or no-cost proposition for employers while glossing over the fees charged to employees. A successful ruse it is. All told, insurers have lured 18,000 companies into parking $185 billion of 401(k) assets inside group annuities and similar insurance contracts, according to an analysis by Larkspur Data Resources of plans with under $250 million in assets.

"Insurance companies cater to the smaller, less sophisticated part of the market," says Robert Prall, managing partner of Rx Investment Solutions, which advises companies on how to build low-cost 401(k) plans. "Every time we've gone into a company that has a group variable annuity contract, no one has really understood how it worked."

One John Hancock group annuity contract allows it to skim off up to 5% of assets before the remains go to work for savers. That's on top of "trailer" commissions of up to 1.4% of assets annually for as long as the plan exists and "asset charges" of up to 4%. John Hancock says those maximum fees provide a distorted picture and that it offers a variety of competitive rates. Why then, you might ask, does another piece of fine print state that John Hancock makes no claim "that any expenses paid directly or indirectly by the plan are reasonable"?

"When it comes to fee abuse in retirement plans, you can put group annuities at the top of the list," says Daniel Maul, an investment advisor in Seattle, Wash. who helps small firms set up 401(k) programs.

Among 401(k) plans with assets of less than $250 million, group annuity-style menus account for 55% of the market and are sold by axa Equitable, Lincoln Financial and other insurers. A few are like the deferred annuities sold outside retirement plans that combine some life insurance coverage with savings features. Those products typically offer investors a choice of mutual funds; the insurance takes the form of a pledge to pay their heirs what they put in if they meet with an untimely end at a point when the value of their assets has fallen. At the end of their careers, deferred annuity holders can receive their savings either as a lump sum or as annuity payments for life.

By contrast, the group annuities containing 401(k) plans often provide neither a meaningful insurance benefit nor an annuitization option. In fact, beyond the same features that plain vanilla mutual funds offer for a fraction of the cost, group annuities' only upside is a tax benefit--for the insurers selling them, not for the 401(k) investors.

It works this way: Inside group annuities, legal title to the mutual funds belongs to the insurers. This ownership bestows on them the right to claim a corporate dividend received credit, an old feature of the tax code aimed at preventing the double-taxation of profits at the corporate level. Investors don't get a special tax benefit. The fact that annuities may be tax-deferred is irrelevant inside a retirement account, which is tax-deferred no matter how it is invested.

The annuity trappings do, however, mean that investors get hit up for higher fees. John Hancock's group annuity offers the JH American Funds Growth Fund of America at a cost of 0.91% annually. Other 401(k) investors can get an identical fund at less than half the cost.

An accountant at a five-person Texas firm was shocked to discover while looking through his 401(k) statements recently that axa Equitable's group annuity was charging 1.69% annually to own its version of an S&P 500 index fund. The 0.64% charged for the fund alone is four to five times what low-cost providers Fidelity and Vanguard charge.

The fact that group annuities are sold at all is largely a function of muddled 401(k) regulation. By styling 401(k) plans as group annuities, sellers can shop for the most lax oversight. That's because regulators let insurers

decide for themselves whether these products are securities, in which case they are overseen by the Securities & Exchange Commission and must be sold with a prospectus disclosing costs and other details. Or insurers can declare their group annuities are purely insurance products. Insurance regulators tend to focus on an issuer's claims-paying ability rather than its disclosure; most states allow insurers to sell group annuities without even issuing a prospectus.

While insurance salesmen are free to present themselves as honest brokers, they are not required to regard themselves as fiduciaries with a legal obligation to put plan participants' interests first. Often they don't.

Among 401(k) plans designed for small companies, the total fees on some group annuities can top $1,000 per participant every year, or three times what low-cost 401(k) plans cost, according to data provider 401kSource. Have second thoughts after signing up and you'll discover that buying a group annuity is like joining the Sopranos.

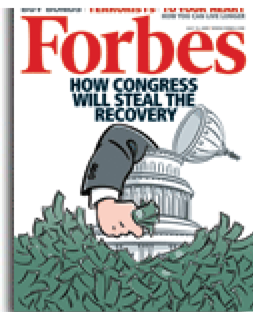
"Surrender charges allow insurers to offer very generous commissions," explains Parker Payson of Employee Fiduciary, a Mobile, Ala. firm that sets up low-cost mutual-fund-based 401(k) plans for small companies. "The annuity provider wants to make sure the client is there long enough to recoup the commission."

Some insurers, including New York Life, refuse to offer group annuities. Deanna Garen, a managing director for the firm, points out that, in theory, retirement savings plans with annuitization features are a great idea. Unfortunately, says Garen, the ones on the market are too confusing and costly.

"They just haven't evolved to the point where there are sensible fee structures," she says.

Customers, for the most part, haven't evolved to the point where they know what's going on. Two-thirds of workers are unaware that they're paying anything for 401(k) plans, according to a 2007 survey by AARP. Another 20% aren't sure. Even among the handful who understood that fees are deducted from their accounts, few could say precisely how much they're paying.

Advice to employees: You don't have to take any of this lying down. Find out what you're paying to have your money managed. If it's too much, complain to the benefits department.



Wooley, Scott. "Retirement Plans From Hell." *Forbes* July 13, 2009. 06.24.09, 06:00PM EDT. <http://www.forbes.com/free_forbes/2009/0713/group-annuity-aig-retirement-plans-from-hell.html>