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CEA Blog: The Retirement Security Rule — Strengthening Protections for Americans Saving for Retirement

Today, the Biden Administration is announcing a new rule proposed by the Department of Labor to close loopholes and ensure that the financial advice that Americans get for retirement is in their best interest. The rule would expand the existing fiduciary standard that commonly covers advice over purchasing securities like mutual funds, to include new types of non-securities like fixed index annuities, advice to employers and plan fiduciaries, and one-time advice for transactions like 401(k) rollovers. The rule will cut junk fees in retirement products, potentially providing billions more in savings for those saving for retirement. This CEA blog explains why this proposed rule change is important for consumers by focusing on a specific, but substantial, market transaction: rolling over retirement savings into fixed index annuities.

As background: in 2022, Americans rolled over approximately $779 billion from defined contribution plans, such as 401(k)s, into IRAs.[1] The decision to roll over assets is a complex and personal one, and investors have many asset choices after deciding to roll over. Current securities laws provide many important protections to people saving for their retirement. Financial advisers for example must generally hew to a "fiduciary standard" when recommending the purchase of securities like stocks and mutual funds, meaning the adviser must put the client's interests above their own commissions. You might think this is always the case in the investment industry, but at the moment, one-time financial advice over transactions like a 401(k) rollover is often *not* required to meet a fiduciary standard under the Employee Retirement Income Security Act, the federal law governing retirement plans. Moreover, securities laws and regulations do not broadly cover recommendations to purchase non-securities, such as real estate, certain kinds of annuities, or commodities like gold. They also don't cover advice to plan sponsors about which investments to put on a 401(k) lineup. These blind spots in the current rules can increase costs and fees for consumers, taking a toll on their retirement savings.

One example of a non-security investment is a "fixed index annuity." Fixed index annuities are financial products typically issued by insurance companies (and therefore governed by state law rather than federal securities law) with features that could be attractive to risk-averse investors. Their returns have both lower upside and downside risk, because they generally cap returns while also putting a floor on losses. This greater certainty however comes with additional costs and fees when compared to investments in comparable mutual funds, as well as extended lock-up periods where investors face fees if they withdraw their money.

The primary source of fixed index annuity costs to investors are the caps placed on returns that the annuity receives from the underlying index it is based upon. Under certain conditions, the cost of the upside cap on returns can outweigh the benefits of the downside protection, in which case the investor could, in principle, get a better deal without a lock-up period. Different financial products have different terms, but in the appendix, we provide an example of how, under the current system, a retirement saver could end up with lower returns than they would under the proposed rule.

[1] Cerulli Associates, *U.S. Retirement End-Investor 2023: Personalizing the 401(k) Investor Experience*, p.145.

There may also be strong incentives for brokers to encourage investment in fixed index annuities even if they are not in investors' best interests. This is potentially evidenced by the large commissions paid to brokers. For example, the annuity mentioned in the appendix gives commissions ranging from 6.5% for sales to under-75-year-olds to 3.5% for sales to those over the age of 80. Many academic papers have examined the impact of conflicted investment advice on portfolio performance across markets.[2] These estimates show losses to returns that range from 95 to 170 basis points in the markets studied. Even taking the conservative estimate of 95 basis points from Egan (2019) — who studies the role of conflicted advice in the sale of convertible bonds — the losses appear substantial. As a rough estimate: the total assets held in fixed index annuities have grown rapidly, from $185 billion in 2010 to $559 billion at the end of 2021. [3] Even if this market doesn't continue to grow, the amount paid by consumers in return caps could be as high as $7 billion annually and the amount lost to conflicted investment advice could be as high as $5 billion annually with respect to just this one category of investment.

Today's proposed Retirement Security rule by the Biden Administration expands protections for retirement savers, ensures sounder financial advice, lowers investment junk fees, and gives every American saving for retirement greater peace of mind about their portfolios.

APPENDIX: ILLUSTRATING THE BENEFITS AND COSTS OF A FIXED INDEX ANNUITY

Fixed index annuities are complex products whose costs and benefits are not straightforward to quantify. At the time of investment, the combination of downside protection and loss of upside potential are equivalent to the investor receiving a put option and giving a call option to the insurance company. Therefore, one way to conceptualize the costs is to use the fair market value of these options.

Market prices change frequently, but purely as an illustrative example: the return cap on Nationwide's Peak 10 Index Annuity, which is indexed to the S&P 500, was 6.75% as of August 2023. The estimated value of that 6.75% contract cap net of a 0% floor to Nationwide during the first year of investment, based on the prices of options on the S&P 500 futures contract, is equal to 1.2% of the total amount invested in the annuity.[4] That suggests that Nationwide could pay the intermediary up to $120 for every $10,000 invested by the consumer, and still expect to make a profit on average. This is the implicit cost to the investor before accounting for explicit sales charges or fees. Pricing these costs and benefits over the entire life of the annuity is even more complex since Nationwide changes the rate caps on the contract each year.

Of course, this example ignores any transactions or operational costs that Nationwide faces. Further, a risk-averse investor might be willing to pay above fair value to insure against the

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[2] Chalmers and Reuter (2014), Christoffersen et al. (2013), Del Guercio and Reuter (2014), Foerster et al. (2014), Egan (2019)

[3] According to the Cerulli report on US annuity markets 2022, page 46.

[4] The estimate is formed with August 1 2023 end-of-day prices, using the historic volatility of the S&P 500 price index on Bloomberg's options pricing calculator. The put option's strike price is at the current index price, and the call option's strike price is 6.75% above the index's price on August 1. The maturity of the option is 1 year (365 days).

possibility of loss. In principle, an investor could construct the same portfolio as the fixed index annuity more cheaply using options, but this is in practice difficult for a retail investor. This exercise simply highlights the lopsided fair value of the contract at the outset; nevertheless, a fixed index annuity may still make sense for certain investors.

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