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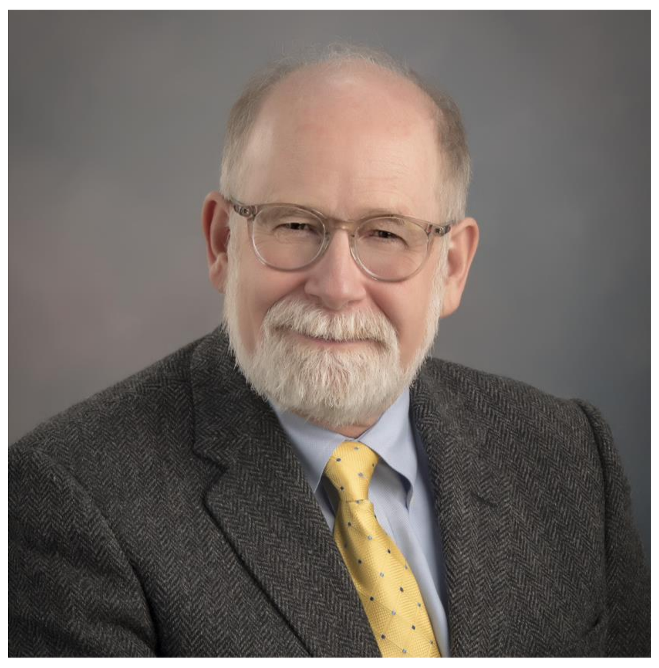
Assessing Guaranteed Lifetime Income Programs Utilizing CITs

ROBERT TOTH

Principal
Law Office of Robert J. Toth, Jr. LLC



ABOUT THE AUTHOR

Robert Toth

PRINCIPAL

Bob Toth has practiced employee benefits law since 1983. His practice focuses on the design, administration and distribution of financial products and services for retirement plans, one which combines elements of ERISA, tax law, insurance law, securities law and investment law for both 401(a) and 403(b) plans.

Bob has extensive experience in the design and implementation of lifetime income programs for defined contribution plans (“DC plans”) including the manner in which insurance products are integrated into their operation. He is widely published on these programs, including on the fiduciary implications related to them.

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Assessing Guaranteed Lifetime Income Programs Utilizing CITs

The SECURE Act (the "Act") adopted new rules designed to encourage the development and ultimate adoption by plan sponsors of a new generation of guaranteed lifetime income ("GLI") options for DC Plans. These legislative changes are having a dramatic effect on the GLI options now available in the marketplace.

Most impactful is the establishment of a safe harbor to protect plan sponsors in selecting an insurance company to provide GLI; the introduction of enhanced portability for GLI products which are purchased by plans; and required lifetime income disclosure to be delivered to participants, at least annually, that expresses their account balances as lifetime income streams – showing how much monthly income their account could produce in retirement.

Post-SECURE Product Innovation

These changes and other recent regulatory actions have led to a number of GLI innovations in the defined contribution market. Among the most prominent innovations are programs that integrate the provision of lifetime income guarantees into managed accounts, effectively making GLI a fundamental feature of a participant's retirement investment portfolio.

With Collective Investment Trusts (CITs) gaining an increasing share of the DC plan assets under management ("AUM"), it's no surprise that several post-Act GLI innovations have been developed for use with CITs. Since CITs provide for lower costs and more flexibility than mutual funds as DC Plan investments, they are particularly attractive to be used in conjunction with the purchase of a GLI program. In the context of CITs, plan sponsors are able to choose between arrangements where:

- **the CIT itself purchases the insurance guarantees** necessary to provide a GLI program, with management of the retirement "glide path" being integrated within the CIT, or
- **the insurance guarantees are purchased directly by the DC Plan** and made part of the plan's own managed account offerings that also include CITs.

These new CIT/GLI programs are being made more attractive by the growing availability of certain annuity product types with features that have not been widely used in the past by DC plans, including the Fixed Index Annuity ("FIA") with the Guaranteed Lifetime Withdrawal ("GLWB") feature.

The common theme among these new GLI programs is that they are incorporated into defined contribution plans as investment options under those plans. This means that plan sponsors as fiduciaries, and any service providers that plan sponsors may hire to handle fiduciary functions, have important responsibilities with regard to the selection and implementation of these programs.

In particular, they are subject to the prudent standard of care under the Employee Retirement Income Security Act ("ERISA") (or under applicable state law) in selecting the investment providers and investment options for a retirement plan.

The purpose of this white paper is to inform fiduciaries of some factors they might want to consider in acting prudently and deciding to diversify a plan's investments by adding a GLI option that provides lifetime income which incorporates the use of a CIT as part of a managed GLI arrangement.

Key Features of FIAs with GLWBs

These products and features provide attractive lifetime income payout options, which are designed to avoid what many advisors and plan sponsors see as critical design disadvantages of both the "straight life" type of annuity payout and traditional defined benefit plan payout. Chief among these disadvantages is the inflexibility of the benefit such payouts provide.

Depending on the platform or the insurance contract through which these insurance features are provided, this inflexibility may be addressed by offering:

- the ability to start a stream of guaranteed income without that choice being irrevocable (i.e., annuitization);
- access to the account balance, which is funding the lifetime income stream, to allow for additional partial withdrawals or a full withdrawal;
- or the ability to accumulate enhanced guaranteed earnings on the value of the contract balance, which is used to fund the lifetime income benefit.

Some FIAs with GLWB designs include the potential for guaranteed lifetime income amounts to increase annually, helping address the corrosive effects of inflation. Such increasing income features may actually start during the accumulation phase and continue even after a participant begins taking lifetime withdrawals.

The Provision of Lifetime Income in Defined Contribution Plans

As noted, there are two distinct ways to deliver guaranteed lifetime income within a DC Plan in the context of a CIT:

1. **CIT embedded GLI**

   A CIT purchases the necessary insurance guarantees, which then can be managed with other investment options in the CIT.

2. **Direct purchase of GLI**

   The DC Plan can directly purchase those guarantees, which can either be managed alongside the plan's CIT or other investments, or be held as a standalone investment alternative within the plan, which can be allocated to by an advice mechanism, or by participants directly.

There are meaningful differences between these approaches, which will be explored in detail in this white paper. For example, CIT based guarantees may not provide the same opportunities/advantages available with GLI options purchased directly by a plan. This includes the personalization and portability of the guarantees; the manner in which the portability and insurer safe harbor provisions of the Act apply, as well as the additional complexity in administering GLI within a CIT structure.

Basics of income guarantees

Assessing the comparative value of these two GLI delivery methods first requires a basic understanding of the manner in which income guarantees work. There are two simple rules that are basic to all DC plan GLI programs:

1. **Guaranteed payout programs are designed to be treated as DC plan investments, instead of as a "benefit" feature offered by a plan.**

   Instead of being made under a benefit schedule contained in the plan document, these GLI programs are made available through the plan's investment lineup, and the payouts are effectively treated as returns on those investments.

   Providing this type of investment structure involves a very particular expertise beyond what the DC plan has historically provided to participants. The delivery of a GLI program is a mathematically and data intensive effort, which uses substantial actuarial resources.

   It requires the vendor to have substantial financial strength through which to guarantee those payments over lifetimes, even through years of economic uncertainty and change. It also requires a durable delivery system, which will be able to administer these longevity payments.

2. **Any actual lifetime income guarantee under a DC plan can only be provided by the purchase of an annuity contract from an insurance company licensed by a state to issue those types of guarantees.**

   Where a DC plan provides access to payouts which are *guaranteed* for the participant's lifetime, the various regulatory schemes effectively require the purchase of an insurance policy (by the plan or the CIT) which is issued by a licensed and regulated insurance carrier. The ultimate impact of these regulations is that those providing the guarantees will be required to maintain financial reserves and controls sufficient to protect participants from the inherent risks in guaranteeing benefits for a lifetime. DC lifetime income programs which do not actually guarantee payments for life are not required to involve insurance.

How a CIT embedded lifetime income program works

CITs are designed to facilitate investment management by combining assets from multiple investors into a single investment portfolio with a specific investment strategy. In providing a GLI option, it is able to take advantage of the pricing scale, which CITs offer; the expertise of the CIT managers to prudently manage those investments to match up with the guarantees in which it also invests; and can bear the fiduciary responsibility to monitor the CIT's manager's performance.

A CIT, however, has no legal authority to guarantee a lifetime income payout as part of its trust offering to multiple plans because it is not licensed by a state as an insurance company. Instead, they are regulated by the federal Office of the Comptroller of Currency (OCC) or under state trust laws, which do not govern insurance.[1]

The result is that a CIT must then engage in extraordinary contractual arrangements with the plan in order to replicate, to the extent it can, the package of guarantees and services that are otherwise provided to plans and participants where a plan directly purchases an insurance contract. In operation this means that the CIT first must purchase the annuity contracts from an insurance company as part of the CIT's investments. Any sort of "income accumulation" or enhanced income rights which may be accumulated in these CIT-owned policies are accumulated as a "class," being keyed to the "age" of the target date fund with which they are associated.

These annuity contracts will only guarantee income payments to the CIT, not to the plan or participant (though it may take into account the age of the target date class in making its payouts). Once the annuities owned by the CIT are in payout status, the payments are made to the CIT. The CIT then treats the insurance payments it receives as investment returns.

To allocate that GLI benefit to a plan participant, the plan then must withdraw a calculated amount of those insurance payouts from the CIT by liquidating a portion of its CIT interests. This calculation is performed by a service company hired by the plan to determine the amount of the plan's CIT withdrawal which should be allocated as a GLI payment to the account of any participants who may be participating in the program.

Additional steps then need to be taken in order for those CIT withdrawals to mirror the value of an insurance guaranteed payout. This involves creating a process which effectively "transforms" the investment returns of the CIT annuity contract back into non-insured systematic withdrawals to plans and participants without actually having an insurance contract, and its associated legal rights, or its state regulated guarantees.

This also poses a challenge for the plan which offers GLI options provided through

[1] Note that there is a short piece describing the operation of a CIT at the end of this whitepaper.

a CIT because CITs do not carry individual plan participant data. The various guarantees are calculated on a “class” basis, and any individual’s participation and interests in that “class” must be calculated and tracked elsewhere. Where the CIT embedded GLI program also provides “income accumulations” (as under a GLWB, for example) which are affected by the program’s investments, these are also calculated at the “class” level based upon the CIT’s investment manager’s choices, as opposed to an individual participant’s own chosen investment risk profile.

How the direct purchase of GLI by a plan works

By contrast, annuity contracts directly purchased by a plan as part of a GLI program can be designed to guarantee lifetime payouts directly to plans or plan participants, as the case may be. A GLI program which uses annuities owned directly by the plan could do so through establishing a managed account within the plan. This balances the purchase of insurance with the purchase of target date CITs (or, in the alternative, mutual fund or ETFs) investments. These managed accounts can qualify as a QDIA.

Any sort of “income accumulation” or enhanced income rights which may be accumulated in these plan-owned policies are accumulated at the individual participant level, not as part of a “class,” as the participants are directly named as the annuitants under those policies.

Annuity payments made to the plan are also treated by the plan as investment returns. However, unlike the CIT arrangement, the amount of the payment (and any enhanced accumulations or income rights) is calculated as part of the payout from the insurance company without the intervention of a third party, and those amounts are directly credited to the participant’s account.

In the alternative, these programs can be designed to have the distributions paid directly to the participant.

These annuity purchases also can be offered by a plan to its participants as a stand-alone, designated investment alternative (“DIA”).

A practical comparison of the two GLI delivery methods

The practical impact of the differences between the provision of CIT/GLI options through CIT-owned insurance and when provided under plan owned insurance can be substantial. These differences become apparent in key areas including portability, complexity, and the personalization of guarantees.

Portability

Plan and participant circumstances change. An important feature of any GLI option is its ability to protect guarantees which may have been accumulated by the participant when circumstances change. This includes, for example, where the participant terminates employment; the merger or termination of the plan; or where the GLI vendor is terminated by the plan.

Limits on Portability in a CIT embedded GLI program

There are structural limitations on the ability of a participant to roll over the guarantees accumulated in a CIT embedded GLI program and to preserve these accumulated guarantees. The basis for these limitations is that the CIT interests providing the GLI programs are exempt from registration under U.S. securities laws. However, these "non-registered" CIT interests are currently prohibited by law from being held by either an IRA or a 403(b) plan.

This creates a significant impact on the portability of the guarantees accumulated under a CIT: a participant's accumulated interests in non-registered CITs (of the sort that offer GLI programs) cannot be directly preserved in a rollover of the CIT interest to an IRA or 403(b) plan.[2] The accumulated guarantees can only be rolled over to another 401(a) plan. Even then, those guarantees can only be preserved in a rollover if the recipient plan has made the same complex contractual arrangements with the same parties that are discussed below because the guarantees rely upon the calculations provided under a service contract between the transferor plan and the CIT GLI vendor.

All of this complicates the ability of the CIT embedded GLI to protect the accumulated guarantees upon changing circumstances, and may force the liquidation of the guarantees when such changes occur. Any protection of the accumulated guarantees require a contractual agreement with an insurer to continue these guarantees under a separately issued annuity contract, which raises the issue of the extent to which the terms (including costs) will be identical to those under which the guarantees were accumulated while in the plan.

It becomes incumbent upon the plan's fiduciary to determine under what circumstances the guarantees will be changed when circumstances change, and what method is used to maintain the guarantees. This includes assessing how SECURE Section 109 (related to the portability of lifetime income programs) can apply where the CIT unit itself cannot be rolled into an IRA.

Direct purchase can address plan and participant level portability concerns

In comparison, and by way of example, the GLI guarantees accumulated under a number of certain types of contracts (such as the individual FIA) which are directly held by the plan may be able to be rolled over or transferred to another DC plan or an IRA, while protecting the accumulated guarantees.

[2] This may soon change with regard to 403(b) plans, as there is proposed legislation which would change securities laws to permit the implementation of the SECURE 2.0 provision enabling 403(b) plans to be funded with CIT interests.

Complexity

Complex contractual agreements underpin CIT embedded GLI programs

The CIT is not designed to manage participant level data in providing its standardized services. To provide GLI, the CIT embedded program must somehow convert its collective investment interests into individual plan participant lifetime guarantees.

This necessarily requires a complex series of coordinated contractual agreements and financial transactions which effectively emulate what may otherwise be provided by the insurer under the annuity policy that is owned by the plan.

This conversion includes the plan and its recordkeeper duplicating the type of insurance company services that insurers are providing to the CIT at the CIT level, as noted earlier. For example, the plan must undertake the legal responsibility to determine which of its own participants are eligible to be allocated income from the payments associated with that CIT GLI investment and in what amounts. Though this task may be performed under a service contract with a provider, this task is still ultimately the responsibility of the plan sponsor.

This means that a key part of the fiduciary's assessment of the CIT GLI program is to understand these arrangements; the demands on the plan and its recordkeepers; the ability of the managers of the GLI to manage the provision of the guarantees over the lifetime of the participant; and the relative costs arising from the number of parties involved to make the program work.

Direct plan purchase doesn't require duplication of work

In contrast to the CIT, the insurance company is set-up to manage participant data, including individual plan participant lifetime guarantees. This simplifies the transfer of data, reducing the number of parties involved as well as the relative costs and complexity of these moving pieces.

Personalization of guarantees

Lifetime payout guarantees are also uniquely personal: they guarantee income for the participant's lifetime. This is typically accomplished in an annuity when purchased by the plan by naming the participant as the "annuitant" in the contract (or a certificate with a group annuity). The participant's life expectancy, annuity's contract value, and payout elections (such as a GLWB) determine the guaranteed income amount a participant will receive over their lifetime.

Collective nature of CIT puts parameters on personalization

A CIT can only provide non-insurance withdrawals to a plan based upon the plan's ownership of a CIT "unit," because of its collective nature. Any individualization at the participant level must rely upon a separate service agreement discussed above. In short, a CIT gives every plan an identical share in the same underlying trust investments. The CIT is therefore limited in its ability to personalize the benefit for individual participant.

Direct purchase delivers personalized protection

A plan directly purchasing guarantees from an insurer under which the participant is named as the annuitant provides quantitatively and qualitatively different guarantees than are available through a CIT. For example, a plan-owned annuity contract enables the insurer to provide enhanced, individualized benefits computed and guaranteed at the participant level, instead of at the collective level required under a CIT.

Additional fiduciary considerations

In addition to the aforementioned impacts, there are also other considerations, which arise from the use of the CIT which should be assessed by the fiduciary.

Application of SECURE's Safe Harbor

Section 204 of the SECURE Act provides relief for fiduciaries in their selection of an annuity provider under a GLI program from liability for the future insolvency of the chosen insurer as long certain representations from the insurance company issuing the annuity contract is obtained regarding its financial capability to satisfy its obligations under the annuity contract.

This relief is granted to the fiduciary choosing the insurance company. In a CIT embedded GLI program, the CIT's investment manager selects the insurance company backing the program, and receives this protection. However, it is unclear whether the sponsor selecting this approach will enjoy this safe harbor protection in its selection of the CIT.

Security of the guarantees

State law protects the guarantees provided by insurance companies to owners and annuitants under the policies it issues, and mandates financial reserves to support guarantees. This means insurance law provides protections to the plan owning the policy, or where applicable, the participant. However, where the CIT owns the policy, the CIT is the insured party. This means that the fiduciary should undertake to assess how those plan and participant guarantees will be protected. For example, state law does not prohibit a CIT from cancelling the guarantees of any participant accumulated under the CIT GLI, as those CIT guarantees are not "insurance" governed by insurance law protections (though there can be serious fiduciary implications should the CIT force such a cancellation).

Permanence of GLI support services

GLI programs not only rely upon the financial wherewithal and permanence of the payer of the benefit, but also upon the permanence of the provider servicing the benefit.

As noted earlier, the mathematical algorithms underlying the plan-owned annuity are built into insurance guarantees provided by the highly regulated insurer to the plan and participant under plan owned policies. In contrast, the calculation of any individualized "guarantee" provided under the CIT to any participant is dependent upon those values being calculated and provided separately from the CIT investment, under a non-regulated service contract. It should be assessed whether these "non-insurance" arrangements will have the longevity necessary to support a lifetime income program.

Impact of plan document changes

The sponsor should assess whether adoption of the CIT lifetime income program may require plan document changes to implement. The plan sponsor may need to determine whether any of those required changes will affect the "pre-approved" status of the plan.

Conclusion

Integrating the use of CITS into a GLI program is an important and valuable tool in managing the provision of lifetime income through the DC plan's investment portfolio. As in most such efforts, fiduciaries find it necessary to balance the features of any such program to determine what best meets the plan's needs. Hopefully, the above descriptions will help with any such assessment.

How the CIT Functions

Assessing the CITs provision of a GLI requires a fundamental understanding of the nuts and bolts of the operation of the CIT.

CITs are fundamentally designed to accumulate retirement plan's assets and are widely used as cost effective alternatives to mutual funds. The CIT is, simply put, an ERISA-compliant way for plans of unrelated employers to comingle their assets in a single pool to achieve scale in investment pricing which may otherwise be available only to larger retirement plans. CITs are designed to operate only at the plan level, and the participant in a retirement plan accrues no rights or claims against a CIT directly. Much like a mutual fund, the CIT itself keeps no individual participant records (including those upon which GLI will be provided to the plan participant). Any such records must be kept by the plan or another recordkeeper, not the CIT itself. CITs are structurally designed solely to combine the assets of unrelated plans for investment purposes.

CITs are financial entities established by banks and trust companies, which are chartered either by a state or the federal government to manage the comingled assets of retirement plans,[3] including those of unrelated employers. The IRS rules refers to these trusts as "81-100" trusts, which grant them tax exempt status as long as specific rules are met.

The federal Office of the Comptroller of the Currency's ("OCC") collective investment regulations are the primary federal banking regulations, which govern the establishment and operation of CITs. These OCC rules are in addition to any DOL and IRS rules which otherwise apply to these arrangements when they are used by retirement plans. A version of the federal OCC rules is typically also used by state chartered banks, as well, which results in a measure of consistency between state and federally chartered CITs.

According to the OCC, CIT operations are complex, and bank management must ensure that the trust accounting system they use has the necessary capabilities to meet the OCC's (or state's) specific processing, reporting rand disclosure requirements. This may include some the details of how the CIT is going to manage the insurance policies it purchases as part of a participating plan's arrangements to use those CIT interests in coordination with its GLI program.

The CIT is established by the bank under those regulations, by which it adopts a plan of operation that details the terms under which it manages and administers the CIT's assets. It is formally established through a Declaration of Trust, and the retirement plan applies to the trust company to be admitted to the trust. The application process is typically outlined in a disclosure document often referred to as an offering circular, participation or subscription agreement. That document details all of the terms and conditions of participating in the CIT, including some the rules, which will apply to the running of the lifetime income program.

This structure means that a retirement plan cannot simply purchase a CIT interest, as it would a mutual fund share, in order to adopt a GLI program. It must first sign that agreement with the trustee, which, however, will only address the terms and operation of the investments of contributions to, and distributions from the collective trust itself. That agreement will need to

[3] Collective trusts interests can also be made available to individuals, but those arrangements are subject to special rules and limitations, including those under securities laws.

be supplemented by agreements with other service providers under which the GLI will operate.

It is worthwhile to also recognize that the collective trust is not just a passive investment holding structure. The CIT is typically organized into separate investment subaccounts referred to as Collective Investment Funds ("CIFs"), each of which are managed and valued separately from each other. The CIT can therefore create a series of target date funds under the same CIT. Each CIF is governed by a formal investment policy which the bank, as trustee of trust, has the fiduciary obligation to implement and monitor.

The trustee then appoints a fiduciary who qualifies as an investment manager under ERISA Section 3(38) whose responsibilities will include executing the investment policy. In a CIT GLI program, each CIF investment policy may be used to establish differing age-based "glide paths" under which income annuities will be purchased as investments of the CIF. There are unique fiduciary demands related to the management and the operation of the guarantees under a CIF, including (but not limited to) the choice of the insurer carrier, the terms of annuity policy and the costs of those policies. The trustee has the responsibility to periodically monitor the performance of the investment manager.

Each of these separately managed CIFs creates participation units which are then purchased by retirement plan, which have signed participation agreements with the trustee. Each participation unit is typically valued daily in the same manner as mutual funds. To the extent an insurance policy is held in the CIF, the value of that policy must be included in the CIF's unit net asset value (NAV)-even if the annuity policy may not have liquid assets. These CIF units are able to be traded daily through the NSCC, the same platform though which mutual funds are traded by plans.

Retirement plans which participate in the CIT are only the beneficial owners of the fund's assets, including any annuity contract in the CIF. This means that neither the plans themselves, nor their participants, have any lifetime income rights under any of the annuity policies purchased under the CIT. This is the case even though CIT is a "look-through" vehicle under ERISA's "plan asset" rules. Though the CIT-owned annuity contracts are otherwise considered reportable assets of the plan, and are subject to ERISA's fiduciary and prohibited transaction rules in the same manner as if those funds were held by a plan itself, the individual plan is not named in the policy, nor is any plan participant named as the insured "annuitant" under those policies. This means that the legal obligations of the insurance company run to the CIT, not to the participant or to the plan.