Comments by the Retirement Security Project on Strategies for Promoting Lifetime Income in Retirement Savings Accounts[1]

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Introduction

Over the next two decades, an estimated 75 million Americans who were born during the postwar years will retire. A major challenge for them is how to allocate their resources when they do not know exactly how long they will live. If they live longer than expected, they face the dire prospect of running out of funds late in life. Alternatively, and perhaps equally unfortunately, they may be too conservative when drawing down their resources and may unnecessarily forgo consumption that they could safely have enjoyed earlier in their retirement.

Lifetime income can solve this planning problem. Individuals who exchange a portion of their retirement savings for guaranteed periodic lifetime payments are assured of never running out of resources. The annuitant has mitigated the risk of consuming too much too soon or consuming too little over time. The annuity provider assumes the risk that the annuitant may live longer than expected (which would require longer-than-expected payments), but can diversify and, therefore, spread this risk across a large pool of annuitants with different probable and actual life spans.

These comments to the RFI include two major proposals. First, we will discuss ways to use behavioral economics to increase the proportion of workers who choose to take a portion of their retirement savings in the form of guaranteed lifetime income products. Second, we will propose the creation of a federal guarantee on such products so that the worker is protected even if the company that sold the income product goes out of business.

The Challenge

Despite the potential benefits, few retirees purchase lifetime income products through the private market.[2] Among current retirees, private annuities account for less than 2 percent

[1] This memorandum draws heavily, including substantial passages borrowed verbatim but without quotation marks, from the following RSP papers: Increasing Annuitization in 401(k) Plans with Automatic Trial Income and Automatic Annuitization: New Behavioral Strategies for Expanding Lifetime Income in 401(k)s.

[2] A large literature has developed that seeks to explain this "annuity puzzle." Early seminal work includes Bernheim 1987; Friedman and Warshawsky 1990; Kotlikoff and Spivak 1981; Mitchell et al. 1999; Yaari 1965.

of total household income.[3] One possible reason for this, supported by a growing body of evidence, is that the individual (as opposed to institutional) markets for lifetime income function poorly. For example, lifetime income products are priced to reflect the higher-than-average survival of current buyers (adverse selection), which makes these products more expensive for the average consumer than they would be if there were a much larger and more diversified group of buyers (Mitchell et al. 1999). A second example is that consumers are unfamiliar with these products, often have misperceptions or biases against them, or may be unwilling or unable to make the effort required to make sensible choices (Hu and Scott 2007). These findings imply that demand would increase and workers would be better off if market function improved and behavioral obstacles were circumvented or mitigated. These problems of pricing and demand will loom ever larger as retirees derive less lifetime income from defined benefit (DB) pension plans and rely increasingly on lump sum payouts from 401(k) and IRA balances (leaving Social Security as their only guaranteed income stream). Indeed, much of policy makers' concern about the shift from DB to 401(k) plans has to do with this current and projected decline in lifetime income.

How should policy makers respond to this decline? The market is developing new lifetime income products that attempt to increase demand by addressing some consumer needs and behavioral obstacles. However, a market solution alone may be insufficient; it appears that these products are not well understood, involve costs that are often not transparent and are at least perceived as often being excessive for average consumers, will have varying success at matching consumers' preferences and needs, and may reach only a select group of consumers. A particular challenge is to ensure that the proposal is flexible enough to accommodate retirees who have varying needs for additional annuitization through private markets since some may already have sufficient protection against outliving their resources through alternative sources such as Social Security, Medicare, and arrangements within their families.

The Automatic Approach

In considering how these obstacles might be overcome with a view to encouraging more lifetime income, it would be natural to consider strategies that include the use of automatic (default) features. The intelligent use of automatic features in 401(k) plans has enjoyed striking success in expanding plan participation and improving investment behavior.[i] There is ample reason to think that the behaviorally-inspired strategies that have worked so well to "automate" and thus improve 401(k) enrollment, contributions, and investment should be extended, as has long been intended, to 401(k) payouts as well.[ii]

Given the success of 401(k) automatic enrollment, would making an annuity the default option at retirement by itself go far toward solving the lifetime income problem? The evidence suggests not. Although a useful element in a strategy to encourage the selection of annuities, the default approach by itself would be far from sufficient. For example, every cash balance pension plan is required by law to make a lifetime annuity the default

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[3] The data are from the Health and Retirement Study and the sample includes adults aged 65 and older in 1999. For more details, see Johnson, Burman, and Kobes 2004.

method of payment, but the vast majority of participants in these plans opt out of the annuity in favor of a lump sum. In cash balance and other hybrid plans, the benefit is framed as an account balance or lump sum, which undermines the effect of the default. Even in traditional DB plans, where the benefit tends to be framed as an annuity, participants often – though not as frequently -- opt for the lump sum if available as an option.

The evidence suggests that, when an annuity is the default and a lump sum is the alternative; most participants opt out of the default in favor of the lump sum, at least where the annuity-versus-lump-sum decision is presented as a momentous, all-or-nothing, irreversible decision affecting one's entire account balance. The force of inertia that gives the automatic or default strategy its power appears to be weakest in these circumstances, and even weaker when the plan has framed the presumptive form of benefit as a lump sum. However, could arrangements be designed to enhance the effectiveness of an automatic or default annuity and make participants more likely to accept it? We believe so.

The Proposals to Increase the Use of Guaranteed Lifetime Income Products
Two complementary strategies could be designed to eliminate or mitigate significant obstacles to the expanded use of lifetime income, without purporting to remove all of the obstacles. Each approach would help address a different, but overlapping, set of concerns, even as innovative product designs also promise to respond to a number of these and other concerns. Both proposals attempt to make it easier for retirees to make sound judgments about financial options that will maximize their retirement security.

An Automatic Trial-Income Strategy
Our first proposed strategy provides for automatic annuitization of assets in 401(k) plans, with the opportunity for participants to "test drive" income products. Specifically,

- Half of a retiree's assets in a 401(k)-type account would be automatically paid as monthly income for a two-year trial period (the default trial arrangement), unless the retiree affirmatively elected a different form of payout permitted under the plan.[4]

- After the trial period of 24 consecutive monthly payments, the retiree could again opt for alternative forms of payment. Those who made no affirmative choice within a specified period would continue to receive monthly payments as the program converts automatically from trial-period income to permanent income.

This approach has several advantages. First, adding "automatic" (default) features to

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[4]Instead of half, the plan sponsor could choose some other substantial portion. The two-year trial default is part of a more general strategy of using defaults to encourage people to choose income solutions. Automatic features to promote the expanded use of guaranteed income could apply directly to the benefit payout decisions plan sponsors and individuals confront in the distribution phase of the plan or indirectly through plan sponsors' and participants' investment decisions toward the end of their careers. The two-year default explores the use of automatic strategies directly in the distribution phase. (The indirect use of automatic strategies in the investment phase to improve distribution decisions is explored in a forthcoming brief by Iwry and Turner.)

401(k)s allows inertia to work in favor of lifetime income, as it has done in increasing 401(k) participation rates and contribution levels (Madrian and Shea 2001; Thaler and Benartzi 2004). Second, the trial income arrangement would give consumers valuable information about income solutions, giving them a tool to appropriately evaluate their distribution options to ensure a more secure retirement. Third, launching a trial income program through 401(k)-type plans, which have millions of participants, has the potential to mitigate the adverse selection problem in lifetime income contracts and to reduce prices. Fourth, the trial program would leave individuals free to address their individual circumstances and preferences: it initially would provide income for a limited time, and workers who preferred to direct the investment of their retirement assets or take distributions in other forms could opt out either before or after the two-year "test drive".

Phased or Incremental Acquisition of Deferred Annuities

The second proposal would involve the phased or incremental acquisition of deferred annuities during the plan's "accumulation phase". This strategy would make the automatic (default) approach a more powerful tool to promote lifetime income by incorporating three simple but important elements:

- *Avoid "all or nothing"*. First, instead of requiring the traditional all-or-nothing annuitization choice, frame the annuity offer as one that allows the account owner to use only a portion of the account balance to purchase an annuity. For many, it might make sense to annuitize only a portion of the account, and that portion might vary from one household to the next.

- *Avoid "all at once"/"now or never"*. Second, allow plan participants to opt for incremental annuitization over time, rather than confronting them with a single "moment of truth" at which the decision whether or not to take an annuity is thrust upon them. A single point-in-time approach can make the decision process more difficult insofar as it entails both the urgency of a deadline and the high stakes associated with a decision affecting the disposition of what may be their entire life savings. An annuitization decision may "go down easier" if divisible not only in amount (through partial annuitization) but in time (through incremental annuitization that avoids a "now or never" choice).

- *Avoid "never or forever" irreversible decisions.* Third, to the extent possible, allow the consumer to reverse all or a portion of the annuity purchase, at least for a time.

These three elements effectively lower the stakes so that one who passively accepts the default has almost nothing to lose.

In the specific context of 401(k) plans, two particularly promising vehicles could incorporate these three elements and encourage participants to accumulate deferred lifetime income over their working lives.

Invest the employer match in deferred annuities. Most 401(k) plans provide employer matching contributions. A plan sponsor could make phased acquisition of annuity income units more likely to occur (or could ensure it would occur) by dedicating its employer matching contributions to this purpose during the investment or accumulation phase, either mandatorily or as a default from which participants could opt out. Either approach would be permissible under current law. This also could have the desirable secondary effect of reducing 401(k) participants' overexposure to the stock of their own employers by replacing the traditional mandatory or default investment of many employer matching contributions in employer stock.

Embed annuities in "QDIA" target date funds. Plan sponsors and financial providers might consider incorporating the phased purchase of deferred annuity units into a Qualified Default Investment Alternative, or "QDIA", specified by the Department of Labor as entitled to a measure of fiduciary protection. Probably the most prevalent form of QDIA to date has been the target date maturity or life cycle fund. Often structured as a composite "fund of funds", the target date or life cycle fund generally invests in a mix of asset classes, consisting largely of diversified equities and fixed income investments. A new kind of target maturity or life cycle default fund could facilitate phased purchases of annuities: the steadily growing fixed income component of the life cycle fund might be comprised of fixed annuity income units that accumulate over time and that would be paid out as an annuity at retirement. Thus, fixed deferred annuity units could substitute for the bond component of the life cycle fund, either entirely or in part. (While variable annuities are invested in equities, fixed annuities tend to be backed up, at least indirectly, by insurance company investments in bonds.) As a result, the percentage of 401(k) contributions used to purchase deferred annuity income units would grow as employees approached retirement.

These new life cycle or target date funds would go beyond the funds currently offered insofar as they not only would serve as an investment but also would help manage the post-retirement spend-down of 401(k) assets. In addition, this strategy would be responsive to many households' anxiety, during the current recession and period of extreme market volatility, about the risks of investing in equities and, in some cases, in 401(k) plans generally. A fixed annuity could protect the annuitant from investment risk. However, this may require new arrangements to assure annuitants of the solvency of the annuity provider or, in any event, the safety of their investment in annuities. In addition, while these strategies should drive down annuity costs because of broader use, reduced adverse selection, and plan sponsor bargaining power, further arrangements will be needed to increase transparency of costs and otherwise promote cost reduction.

Federal Guarantees on Lifetime Income Payments

A continuing concern or both employers and workers in the wake of the 2008 financial crisis is whether the firm that has underwritten annuity-like products will actually still be in business and able to provide those payments several decades in the future. This question arises in virtually every discussion with employers about annuity-like products, and is often raised in discussions with legislators.

Under existing law, annuities are insurance products regulated for the most part by states, and covered in the event a company fails by state guarantee funds. These funds insure up to the present value of an annuity contract up to a set ceiling, usually $100,000. Most state guarantee funds would pay the difference between the assets available from the failed company for such products and that ceiling from assessments on the remaining companies offering annuity products in that state.

However, the guaranteed amount of $100,000[5] present value may be substantially less than the value of a worker's actual contract, and result in a sharp cut in his or her monthly income. In such a situation, not only would there be a loss of confidence in the remaining private sector annuity providers, but there would also be political pressure on Congress to quickly establish a federal policy. Non-annuity guaranteed lifetime income products are uninsured since the underlying assets are primarily a worker's own retirement savings balances.

Rather than making policy during a crisis, it would be far preferable to establish a federally backed and uniform guarantee for annuity-like products well in advance of any actual need. This additional perceived safety would encourage workers to purchase annuities and other such products at least up to the maximum guarantee amount.

A number of models could be used to structure the federal guarantee, including a mechanism based on the private sector reinsurance market with an underlying federal guarantee, and an FDIC-like insurance system funded by premiums. In all cases, such a guarantee would also include a requirement that underlying assets meet certain accounting and regulatory standards, and perhaps be segregated in some way in the event an issuer becomes insolvent. The guarantee could apply to both insurance company issued annuities and to other guaranteed lifetime income products offered by other types of companies.

Conclusion

With increased reliance on 401(k) plans in the U.S. retirement income system, an important challenge facing the system is to help retirees manage the risk of outliving their assets. Each of the "automatic" or default strategies outlined here – the incremental acquisition of lifetime income through employer 401(k) contributions or by embedding a deferred annuity in a QDIA, as well as the Gale-Iwry-John-Walker automatic trial income proposal -- is designed to draw on experience and insights from behavioral economics to help replicate, within the 401(k), one of the valued features of the traditional DB pension: guaranteed lifetime income at group rates (and combined, in most cases, with professional investment management).

In addition, retirees need to have the security that their retirement income will not be reduced or ended if the private sector provider of that policy runs into financial difficulty or even goes out of business. While existing safety mechanisms will certainly reduce the probability of such a calamity, they need to be reinforced by some form of federally backed guarantee that both workers and employers can easily understand and rely upon.

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[5] The actual amount of monthly income guaranteed under state guarantee funds would vary according to the age of the contract owner at the time the company fails.

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[i] See Madrian and Shea (2001), Gale et al. (2004), and Gale and Iwry (2005).

[ii] A related goal would be to encourage portability through rollovers. This related topic, which is beyond the scope of this paper, is addressed in J. Mark Iwry and David C. John, ' " [testimony before Senate Aging Ctee June 08].