A Proposal to Increase Annuitization of 401(k) Wealth Using Automatic Features

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Source

• 2008 Paper with several co-authors
  – http://www.brookings.edu/research/papers/2008/06/annuities-gale
  – William Gale (Brookings/RSP)
  – Mark Iwry (then RSP, now Treasury)
  – David John (then Heritage, now AARP)
  – Lina Walker (then RSP, now AARP)

• That paper and this presentation represent the views of the authors, not any of the organizations with which they are or were affiliated
Increasing need for annuitization

- People reaching retirement with more cash balances, as the shift from DB to DC continues and the DC system reaches full maturity

- Lifespan continues to increase, making the prospect of running out of funds more salient

- But annuitization rates are low
  - The industry is growing and evolving, but is still far from full saturation
Barriers to Market Expansion

- **Demand-side issues**
  - Many people are substantially annuitized by SS and Medicare, don’t need more
  - Adverse selection raises annuity prices
    - the return quite low (especially now)
  - Consumers often have no experience converting large cash balances to annual flows and asking them to do it all at once on a permanent basis makes them leery
  - Several consumer biases work against annuitization
    - Big/Small Problem (managing cash balances)
    - “Hit by a bus” Problem
    - People don’t trust insurance companies
    - Annuities often packaged as safe, low-return investment, rather than consumption stabilization tool

- **Supply side issues**
  - Brokers often do not like to sell annuities, since it eliminates the possibility of churning investment (and generating commissions)
One Approach to Raise Participation

• Leverage automatic features, which have been shown to be powerful in other contexts
  – Automatic enrollment has raised enrollment
  – Automatic escalation has raised contributions
  – Automatic investment has helped people avoid some of the worst situations (e.g., putting it all in company stock)
Two concerns with Automatic Features

• People tend to stick where they hit – so need to choose the default carefully

• Automatic, permanent annuitization would be a really bad idea
  – Annuitization needs vary significantly
  – Costs of getting a permanent annuitization wrong are large
Our Proposal

• Automatically default 401(k) holders into an annuity that is
  – Partial -- Covers a certain % of their balance (say 50% or 75%)
  – Temporary -- Goes for two-years

• At the end of two-years, they can opt in or out
The basic motivation

• Encourage people to try annuities
  – Most people have no experience converting large cash balances to annual flows (gets over big/small problem)
• ...In a way that respects their option to choose and recognizes heterogeneity in demand,
• ..Without locking them in forever
• ...and has a large enough pool of retirees to get over the adverse selection problem
Conclusion

• We want to reframe retirement income choices

• Provide people with information and experience dealing with periodic retirement payments before asking them to commit to the long-term

• Set a focal point by using automatic features