

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