THE HAMILTON PROJECT

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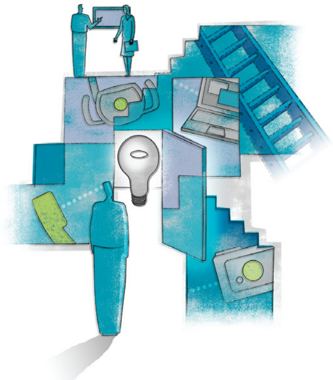
Increasing Annuitization in 401(k) Plans with Automatic Trial Income



MANY MEMBERS of the baby boom generation, the eldest of whom have begun taking early retirement, will have the resources to live comfortably to the age of seventy, seventy-five, or even eighty. But even that may not be enough; a woman who is sixty-five today has a 50 percent chance of living until she is eighty-five, and nearly a one in three chance of reaching ninety. What if she depletes her savings before she dies? Social Security guarantees nearly all retired workers and their spouses a regular income until they die, but for the average workers that resource replaces only one-third of preretirement income. Millions of Social Security recipients also receive regular income from their employers through defined benefit (DB) pension plans, which have traditionally provided lifetime monthly payments, but private DB plans are quickly vanishing in favor of 401(k)-style defined contribution (DC) plans, which most often make lump-sum payments.

In a paper for The Hamilton Project, a diverse group of retirement experts—William G. Gale and J. Mark Iwry of the Brookings Institution, David C. John of The Heritage Founcation, and Lina Walker of the Retirement Security Project—propose a strategy for expanding the role of lifetime income in 401(k) plans. Like Social Security, lifetime income payouts from private-sector plans, also called annuities, guarantee a regular monthly income. At present, however, few retirees find annuities attractive due to problems created by the limited market for annuities as well as behavioral biases against annuities. The authors argue that these drawbacks can be overcome. They propose that 401(k) plans offer an automatic two-year trial of monthly payments to give retirees the opportunity to experience the benefits of monthly income and help overcome some of the biases against lifetime income products. Retirees would have the option to opt out of the trial both before and after the two-year trial period.

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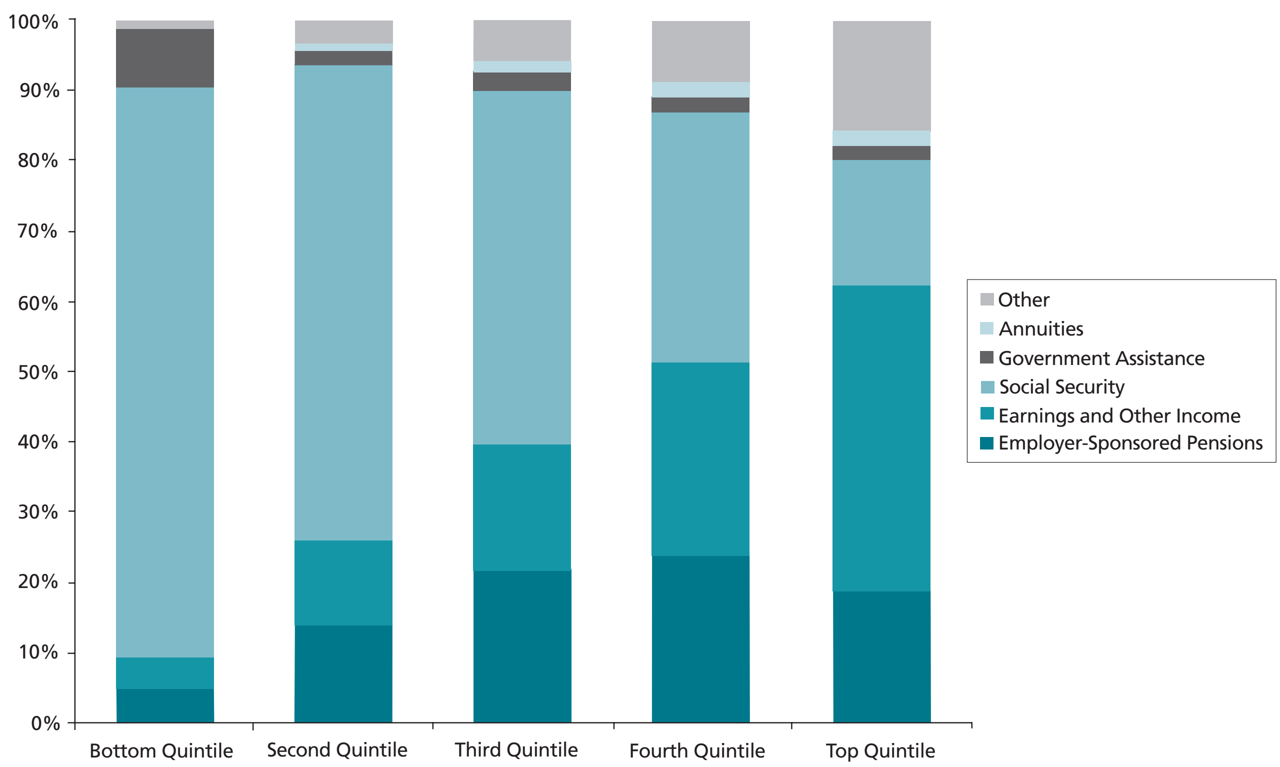
THE CHALLENGE

One in four people living in America today—the 75 million Americans born during the post-World War II baby boom—will reach the retirement age of sixty-five within the next twenty years. Each of those retirees will have to decide how much of their savings to spend at any given point. The uncertain period of time they have left to consume their remaining resources complicates their decisions. If they consume resources too quickly, they may outlive their saved assets; alternatively, if they are too conservative, they may live frugally only to die before they have the chance to enjoy what they had saved.

For many retirees, the best option might be to receive a constant stream of monthly payments rather than a lump-sum payment that they must decide how to allocate. Social Security, which nearly all retirees receive, already guarantees a steady lifetime income stream. Many beneficiaries believe that this income will serve as a safety net in case they go through their private savings, but in reality Social Security payments replace only a fraction of preretirement income. As Figure 1 demonstrates, Social Security provides less than half of retirement income for families with incomes in the top three quintiles.

Many retirees could benefit from using their 401(k)s and other accumulated savings to buy an annuity at retirement. Private annuities are insurance products that "insure" against long life: retirees turn over all or part of their savings to insurance companies or other providers, which then pay retirees a monthly stipend for the rest of their lives. Through pooling everyone's risk of outliving their assets, the insurance

FIGURE 1. Share of Household Income from Different Sources, for Adults Ages 65 and Older, by Household Income Quintile, 1999



Source: Johnson, Burman, and Kobes 2004

companies are able to guarantee lifetime payments for all. For many retirees, this option has the virtue of lifting the burden of planning their financial future and eliminating the risk of over or underconsuming in retirement. Yet, attractive as such an arrangement might seem, private annuities currently account for less than 2 percent of the income of retired households.

In their paper, Gale, Iwry, John, and Walker seek to explain the low take-up rates of such a seemingly useful product. They argue that the current market for annuities functions poorly. Prices of annuities are too high due to the classic phenomenon of adverse selection. People who suspect they may live especially long lives are the most likely to purchase annuities. If insurance companies believe that the average annuities customer will live longer than the population as a whole, they will offer monthly payments that the average retiree thinks are too low. This problem is difficult to correct: average retirees will find annuities to be a good value only when the pool of buyers increases, but the pool of buyers will not increase until annuities are a good value. In addition, the small size of the market raises administrative costs, making annuities even less attractive.

The current annuities products offered are also too complex for the average buyer. It takes no small effort to evaluate the options and sort out which is best. There are annuities that offer death benefits or cashout options and others that do not. Some pay based on fixed interest rates while variable annuities gain or lose with the stock market. Some of these stock-based annuities, by allowing the owner to lock in some investment gains, offer protection against falling equity markets. The average consumer may not have the financial sophistication to sort through all of these options, or even know that they exist.

The complexity of current lifetime income products also contributes to behavioral biases against their use. Research demonstrates that consumers often do not make decisions in their self-interest when faced with complicated choices. People will often choose the simpler option or postpone making decisions because the cost of gathering information to make the right choice is too high. In the case of retirement distribution options, in 401(k)s and similar plans, the easy choice is to stay with the status quo, lump-sum payments from their 401(k)s.

> Since retiring workers in the future will have a lower proportion of their assets annuitized, it is likely that they will want more protection against outliving their assets.

Although annuities may not be popular today, lifetime income is likely to become increasingly important to successive generations of retirees due to changes in the way workers save for retirement. Current retirees generally receive lifetime income from Social Security, and from DB plans that provide a lifetime pension. Workers today, however, increasingly have DC plans, such as 401(k)s, into which they contribute a part of their salary over their working years and then generally receive that money in a lump-sum at retirement. Retiring workers in the future will have a lower proportion of their assets automatically annuitized, making it more likely that they will want additional protection—beyond Social Security—against outliving their assets. With simpler, low-cost offerings, lifetime income products could become a more popular way to help maximize retirement security.

Key Highlights

The Challenge

Despite their many benefits, annuities—products that convert lump-sum payments into a monthly stream of income—account for only 2 percent of all retirement savings. As the use of 401(k) accounts grows, they will replace the monthly pensions that many retirees were accustomed to receiving from employers. Retirees will receive more and more money in lump-sum payments, leaving Social Security as the only stream of income. Annuities could fill this gap, but right now they are not well understood, and the annuities market is not developed enough to provide products that are priced for the average consumer.

A New Approach

Gale, Iwry, John, and Walker propose changing the mindset about annuitized assets by offering retirees a chance to "test drive" regular monthly payments.

- **A portion of assets in 401(k)s or similar accounts** would be automatically distributed in the form of regular consecutive monthly payments for a trial period of two years unless workers opted out of the program.
- **After the trial income period,** participants would be able to choose to continue with an annuity-like lifetime income product or receive their assets in a lump-sum payment. If no decision was made, participants would continue to receive the monthly payments.
- **The trial period would counteract behavioral biases,** but it would also help address the current failures in the annuities market. Through the trial period, plan sponsors would be required to offer a basic annuity that would appeal to more customers. As a result of broadening the market, prices would fall.

This program builds on the success of automatic 401(k) enrollment, which has increased retirement savings rates significantly. Changing the default option for 401(k) distribution choices could have a parallel effect in this market by increasing annuity enrollment and helping retirees manage financial risk in retirement.

A NEW APPROACH

How to address the retirement challenge? Gale, Iwry, John, and Walker offer one answer. They want to make it easier for retirees to make sound judgments about financial options that will maximize their retirement security and minimize their potential harm. Reforming the nature of annuities and better communicating their benefits to retirees would help achieve this goal.

Their plan is conceptually simple: they would make annuitization of 401(k) savings at retirement the default option unless retirees opt out, either immediately or after a two-year trial period. At present, accumulated 401(k) assets are made available to the retiree as a lump sum. Retirees can use this lump sum in any way they see fit. They can roll it over into a new retirement account, take it to Las Vegas, or convert it into a steady income by buying an annuity. If they make no decision, then they take possession of the assets and either pay income taxes on them or deposit them in a tax-advantaged retirement account. By far the majority of 401(k) participants take direct possession of their retirement savings. This, the authors say, reflects the bias for the status quo—the tendency to go wherever inertia takes you. This bias is particularly strong when, as is the case with retirement, the choices are so complex.

The authors would use people's status quo bias to the advantage of lifetime income products. A portion of the 401(k) savings would be used to provide monthly income unless retirees affirmatively choose otherwise. After two years of experience with a steady income, retirees would be given a chance to withdraw from the program. Those who did not opt out would remain enrolled in the lifetime income product for the remainder of their lives.

The trial would help familiarize retirees with lifetime income products, giving them the information and experience to make informed choices about how to manage their retirement resources. An analogous approach designed to encourage more retirement savings among workers has already met with considerable success. Studies show that when workers must take affirmative steps to research and enroll in 401(k) plans, many workers never end up participating. But if workers are automatically enrolled in the very same savings plans and given the option of opting out, participation rates increase significantly—nearly doubling for some plans. The authors believe that the law of inertia that works on the savings side of retirement planning would also work in a different form—structured as a trial affecting a portion of the worker's savings—when it comes time for retired workers to take possession of their savings.

Under the authors' approach, workers would not seal their fate for life by taking the lifetime income option at retirement. They would merely be signing up for a two-year "test drive" of lifetime income to give them a chance to experience retirement on a steady income. Would their monthly annuity checks be enough to pay the bills? Would retirees have enough left over to enjoy an occasional meal out or to visit the kids? The authors predict that many retirees would quickly become accustomed to consistency, security, and simplicity of receiving regular monthly checks—and would stick with the lifetime income product after the two-year trial ended. Even if they ultimately decided against lifetime income, retirees would be doing so on a more informed basis.

Structuring the Trial

The two-year lifetime income trial would be triggered when retirees withdraw a substantial portion of their 401(k) assets. The threshold amount that triggers the trial could be an absolute amount or a percent of the account balance—for example, $10,000 or 10 percent of the account balance, whichever is greater. The trial would only be a default for those 401(k) participants over a certain age (perhaps fifty-five) in order not to interfere with the portability of retirement savings.

The authors would leave many of the specific questions up to the plan sponsors. Plan sponsors could decide how much of a retiree's 401(k) savings would be subject to the income option during the two-year test drive. Government regulators would set guidelines—somewhere between one-third and three-quarters of savings, for instance—and the sponsors would choose any fraction in that range. Employers sponsoring two-year trials of the lifetime income option could choose to administer the monthly payouts themselves, or they could arrange for an outside provider to take over the task, much as they retain financial services companies to administer their 401(k) savings plans.

Sponsors could exempt retirees with small amounts of saved income from the lifetime income program. Half of a $30,000 account, for example, might support a monthly payment of $80. Such a small payment might not justify incurring the administrative costs of a lifetime income product. From the perspective of this retiree, a lump-sum payment might be a better option to supplement monthly Social Security payments.

Lifetime income products come in many varieties, and plan sponsors could choose providers offering

> The proposal would use the status quo bias to advantage lifetime income options, offering a two-year "test drive" of monthly payments to give retirees a chance to experience retirement on a steady monthly income.

> Annuitization of 401(k) assets would work best with complementary policies to increase the safety of lifetime income products, enhance their attractiveness, and keep consumers informed.

products that would be particularly attractive to their retirees. For example, sponsors could look for providers offering plans that would:

- compensate the family of a retiree who died during the trial period by giving survivors the unpaid monthly payments or providing monthly payments for a fixed period of years;
- provide the participant with the option to make withdrawals given certain circumstances;
- provide benefits protected against inflation;
- guarantee a minimum level of monthly benefits; and
- increase monthly payments based on its market value.

At the end of the two-year trial period, the plan sponsor or the provider would be required to spell out the options available to the retiree. The retiree could choose continuation of the annuity, but could also opt to discontinue.

The authors argue that the trial would take some of the gloss off the lump-sum options and increase the familiarity with lifetime income products. No longer would that big payment all at once look so attractive. For many retirees, the consistency, security, and simplicity of receiving regular monthly checks would tip the balance in favor of continuing the lifetime income.

Additional Implementation Issues

A number of issues must be addressed before annuities can become the choice for 401(k)-type savings at retirement. In particular, lifetime income purchasers and their former employers would have to be protected against excessive costs, and the security of potentially billions of dollars of investments in lifetime income products would have to be guaranteed.

Increasing safety. Inevitably, one of the companies providing lifetime income products will eventually fail. What happens to its unlucky clients, who stand to lose their retirement nest egg? Safeguards in place today for the relatively small annuities market seem inadequate. One possibility is to provide federal insurance up to a specified maximum level. The authors suggest that such an insurance entity could function somewhat like the Federal Deposit Insurance Corporation, which insures bank deposits up to $100,000. In order to obtain such insurance, providers would be required to pay an annual premium and meet financial and management standards.

Making lifetime income more attractive. Rules governing 401(k)s generally require that assets be withdrawn starting at age seventy and a half, lest tax breaks intended for retirement security be used for estate planning. The tax penalties applied to assets not withdrawn by that time could limit insurers' ability to provide annuities, since monthly annuity amounts could be smaller than the amount required to be withdrawn before age seventy and a half. To encourage annuities, lawmakers could relax these rules for plans that combine 401(k) accounts and annuities.

Likewise, a 10 percent early withdrawal penalty applies to funds withdrawn from 401(k) plans before age fifty-five (or fifty-nine and a half for persons still employed by the plan's sponsor). Triggering the default trial period at age fifty-five would ensure that no withdrawal for a lifetime income product will incur a penalty. For those still employed by the plan's sponsor, it might be necessary to change the law so that the trial program would be exempt from the withdrawal penalties they would otherwise incur before the age of fifty-nine and a half.

Informing consumers. Lump-sum payments have a strong advantage in the minds of many consumers. The authors realize that changing the current mindset about retirement saving will not be easy. The national conversation needs to change the terms of the discussion about retirement savings—not to emphasize the total amount of money that will be available upon retirement, but rather to emphasize the monthly income that the savings can generate. This would help make lifetime income the standard way of thinking about retirement savings. For those individuals who continue to prefer lump-sum payments, nothing in this proposal will preclude their choice. People are still free to opt out of automatic lifetime income if they wish.

CONCLUSION

Many new retirees, upon exploring the options available today for taking control of their 401(k)-type savings, conclude that annuities are simply priced too high, so they opt to take their savings in a lump sum. This is partially attributable to the fact that the market for them is so thin. That will change as total 401(k) assets more than quadruple by 2040. The market for lifetime income products will grow with 401(k) savings, and it would get an additional boost from the proposal to make lifetime income the default mode of 401(k) distributions. Doing so would help enhance retirement security in many individuals by providing them with more certainty about the size of their monthly incomes.

As the market for lifetime income products becomes stronger, their prices will come down and people will become more familiar with them. As the barriers come down, demand will continue to grow. As this virtuous circle gains momentum, annuities could become the financial vehicle of choice for many of the nation's elderly to comfortably live out their retirement years.

Learn More About This Proposal

This policy brief is based on The Hamilton Project discussion paper, *Automatic Trial Income: A Srategy to Increase Annuitization in 401(k) Plans,* which was authored by:

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Additional Hamilton Project Proposals

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The Project is named after Alexander Hamilton, the nation's first treasury secretary, who laid the foundation for the modern American economy. Consistent with the guiding principles of the Project, Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces.

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