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From saving to spending:

A proposal to convert retirement account balances into automatic and flexible income

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Retirement Security Project
at BROOKINGS

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers. Nearly half of all workers do not have access to an employer-sponsored retirement savings plan or a traditional pension. Among workers who do have access to such a plan, the shift from defined benefit pension plans to defined contribution plans makes it even more important for individuals to save for their own retirement. To address these trends, RSP proposes research-based policy solutions aimed at helping middle- and low-income Americans to better prepare for a financially

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ABSTRACT

Converting retirement savings balances into a stream of retirement income is one of the most difficult financial decisions that households need to make. New financial products, however, offer people alternative ways to receive retirement income. We propose a default decumulation solution that could be added to retirement plans to simplify decumulation choices in much the same way that automatic choices have simplified enrollment, contribution, and investment allocation decisions for millions of savers. Our proposal centers on pooled investment accounts known as managed payout funds that deliver monthly income that is likely, though not guaranteed, to last a lifetime. Coupled with longevity annuities that begin to make payments when the owner reaches an advanced age and a separate fund for emergencies and extraordinary payments, managed payout funds could help protect retirees from longevity risk without unduly reducing their current living standards.

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I. Introduction

In a recent nationwide poll, 73 percent of Americans said they do not have the financial skills to manage their money in retirement.[1] Converting retirement savings balances into a stream of retirement income creates difficult choices. The necessary decisions – made in the presence of uncertainty about investment returns, future healthcare expenses, lifespan, and other factors – must balance the twin desires to boost current living standards and to avoid outliving one's assets.

For many people, the solution will involve some form of guaranteed lifetime income – benefits that will be paid regularly as long as the individual survives. Social Security benefits, for example, provide lifetime income, as do payments from defined benefit (DB) pension plans. However, Social Security only provides a modest income for most people, and DB pensions are disappearing in the private sector. The only other way to generate a guaranteed lifetime income stream is through a commercial income annuity, but very few people purchase these contracts.

New and innovative financial products, however, are disrupting traditional markets by offering alternative ways to receive retirement income. The new approaches combine existing products in new and different ways. While they do not always provide guaranteed lifetime income, the innovations nevertheless can give savers options and features that annuities do not provide.

In this paper, we explore these non-annuity options and propose a default decumulation solution that could be added to retirement plans in much the same way that automatic choices have simplified enrollment, contribution, and investment allocation decisions for millions of savers.[2] Our proposal centers on pooled investment accounts known as managed payout funds that deliver monthly income that is likely, though not guaranteed, to last a lifetime. Coupled with longevity annuities that begin to make payments when the owner reaches an advanced age, managed payout funds could help protect retirees from longevity risk without unduly reducing their current living standards. Unlike many annuities, these managed payout funds are also flexible enough to allow retirees to revise their decisions as circumstances change.

Retirement systems across the world are dealing with the same issues and coming to many of the same conclusions. While still in its early stages, this growing international consensus is similar to the one that has prompted the spread of automatic enrollment and similar features to many countries.

Section II provides background information on the need for guaranteed retirement income and the role of annuities. Section III discusses managed payout funds in the United States and in other countries. Section IV proposes an automatic and flexible retirement income solution for American savers. Section V concludes. An Appendix reviews current

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[1] Oakley and Kenneally (2019). In the same poll, 79 percent said that retirees don't have the investment skills to ensure their retirement savings last throughout retirement.

[2] A companion paper explores ways to change annuity regulation to encourage more annuity options to be offered and selected in defined contribution plans (Iwry et al. 2019).

retirement income discussions and evolving proposals in the United Kingdom, Australia, New Zealand, and Canada.

II. Annuities and the Need for Guaranteed Income

Social Security is the primary source of retirement income in the United States. The program provides at least half of income during retirement for more than three-fifths of beneficiaries and at least 90 percent of income during retirement to more than one-third of beneficiaries.[3] Yet, it is widely agreed that most U.S. households need additional sources of income to maintain pre-retirement living standards.

Individual savings have always played a role in providing retirement income. Until relatively recently, many retirees also received income from employer-sponsored DB pension plans. These plans typically pay regular monthly benefits or, in many cases, optional lump sums, based on a formula that normally accounts for highest earnings, tenure with the employer, and other factors. However, they have covered fewer workers in the private sector over time, due to a variety of reasons. For many private sector employers, retirement savings plans – predominantly the 401(k) plan for employer-sponsored retirement benefits and the Individual Retirement Account (IRA) for individual savers – have replaced DB plans.[4]

The strengths and weaknesses of these plans during the saving phase have been extensively discussed elsewhere and are beyond the scope of this paper. Retirement savings plans place the burden of funding retirement benefits on the worker, although many employers provide some matching contributions. The amount of retirement income from those plans is limited to either the contributions plus any investment returns or the level of benefits those assets can buy. This exposes the saver to the risks associated with poor investment returns as well as the possibility of running out of funds in old age. In one survey, about two-thirds of adults believe there is a chance they will outlive their retirement savings.[5] Simply withdrawing savings without guidance can lead to problems. Poterba, Venti, and Wise (2011) found that wealthier retirees tend to be conservative about withdrawing their retirement assets, possibly due to a desire to leave a bequest, while those who are poorer tend to withdraw assets more rapidly.

While some retirees are willing simply to draw down their savings, exposing themselves to investment and longevity risks, others choose the more stable and certain income streams that annuities provide. The traditional form of annuity – an income annuity – is a contract with an insurance company in which an individual purchases a guaranteed income

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[3] Social Security Administration (2017).

[4] Employees in the non-profit and public education sectors are eligible for 403(b) plans; federal employees and certain state and local government employees are eligible for 457(b) plans. Some employers may offer more than one type of account. These plans are similar in structure to 401(k) plans. By contrast to the private sector, DB plan coverage in the public sector has suffered only a moderate decline.

[5] Northwestern Mutual (2018).

stream in return for a set premium. In an immediate annuity, the most well-known type, purchasers pay a lump sum in advance for the right to a regular, scheduled amount of income for the rest of their life. Payments start either immediately or in the near future. In many such contracts, savers can choose a range of additional features in return for a smaller monthly benefit. These include joint and survivor benefits for the lives of two married annuitants, a guarantee that payments will be made for a fixed period to the owner or designated beneficiary, or a lump-sum death benefit.

A deferred income annuity is similar, but it delays the start date of payments, usually several years into the future. In return for the delay, the annuitant receives a higher monthly payment. In theory, if the purchaser dies before benefits begin, the purchase price is lost to the insurance carrier. However, as with immediate annuities, most companies offer various types of guarantees, such as a lump-sum death benefit or a guarantee that payments will be made for at least a set number of years in return for a reduced monthly payment.[6]

In principle, the guaranteed income stream provided by annuities offers fairly obvious value for many retirees. Retirees face competing risks in deciding how much to spend each year. The more they spend, the greater the risk of outliving their assets – especially given the sequence-of-returns risk of having to fund monthly income payments by selling assets while their value is at a temporary low point in a falling market, so that later market rebounds will be operating on a diminished capital base. On the other hand, if they spend too little, they unnecessarily sacrifice their living standards. An income annuity provides a powerful means of resolving this trade-off. Guaranteeing a fixed level of income for life eliminates uncertainty – protecting retirees from depleting their savings too soon while giving them guidance as to how much they can safely spend without concern.

Surveys show that retirement savers value guaranteed lifetime income (Figure 1). Benartzi, Previtero, and Thaler (2011) show that many savers are interested in and value annuities. Yaari (1965), Mitchell et al. (1999), and others demonstrate the value of annuities to retirees under a variety of assumptions. In practice, however, annuity reserves account for about 8 percent of U.S. retirement market assets – a share that has been fairly constant since the mid-1980s, fluctuating between 7.3 and 10.0 percent.[7]

These figures, however, overstate the amount of retirement-income-related annuity assets because much of the "annuity" market consists of products that are not expected to provide a stream of guaranteed lifetime income. Instead, these products – variable, indexed, etc. – are designed to function as equity-based investment products with accumulation features that benefit from the tax-deferred treatment originally intended for life insurance or life annuities. At the beginning of 2018, $453.7 billion was held in fixed annuity

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[6] Other types of annuities exist, but they are not generally used or recommended as vehicles for retirement income. Instead, they are often complex and high-cost tax-favored investment products seeking accumulation of value. In variable annuities, the purchase price is invested in various assets (often mutual funds), and growth (or future income payments, if any) are determined by the performance of the underlying investments. Indexed annuities track a market index (or an index developed by the annuity company) and provide a portion of the growth in the index in exchange for downside protection if investments do not perform as expected (for example, through minimum payment guarantees), all at an additional cost. While variable and indexed annuities can benefit from strong market growth, they also have similar investment risk to traditional investments. Thus, the payments from these contracts may end up being significantly lower if investments do poorly, and the fees and commissions are often significantly higher than many other investment choices. Other types of annuities, such as those that guarantee a stream of payments for a set period, are often used for income smoothing or tax shelter purposes and are beyond the scope of this paper.

[7] Investment Company Institute (2019).

assets, consisting of 15 percent of the total assets held by forms of deferred annuities and less than 2 percent of overall retirement assets.[8]

Relatively few people purchase annuities to provide retirement income. The major industry trade group reports that only about 100 immediate annuities, the one most used for retirement income, are sold per day in the United States. This amounts to about 1 percent of the more than 10,000 baby boomers retiring each day.[9]

Many factors combine to limit utilization of annuities. The presence of Social Security reduces private annuity demand significantly and the remaining demand for this product is very price sensitive.[10] Friedman and Warshawsky (1990) show that annuities generally are expensive. Individuals who desire to leave bequests will have reduced demand for annuities as well.[11]

Consumers' perceptions also play an important role. Consumers often are affected by the "wealth illusion" of perceiving their 401(k) balance as far more valuable than its income (or annuity) equivalent. They also may not prefer annuities due to perceptions of unfairness. In one study, people who believed that it was unfair for insurance companies to keep any remaining assets after an annuitant's death were unwilling to consider annuities even after being shown options where the value of the product to the purchaser far exceeded the cost.[12]

For competitive reasons, many investment firms and advisors have long refrained from selling annuities because they would reduce the advisors' assets under management. In many instances, their criticisms and unfair or debatable attacks have stuck (such as comparing income annuities unfavorably to diversified investments based on return on investment projections without regard to the value of the guarantees). For their part, annuity companies and distributors seeking to compete with the investment industry have designed relatively complex and nontransparent accumulation products. In some cases, they have also engaged in aggressive sales tactics and charged high commissions and surrender charges. Certain providers and advisors have presented annuities as investment opportunities rather than as guaranteed income, thus deemphasizing less profitable simple income annuities, even though Brown et al. (2008) show that people respond more favorably to annuities that are presented as consumption insurance compared to those presented as investments. The large number of features and products for annuities may also scare off investors. Brown et al. (2019) find that complexity reduces investors' ability to value annuities and hence makes them reluctant to purchase them.

Plan sponsors generally have hesitated to include annuity contracts in their 401(k) plans, largely because they believe it might expose them to liability if the annuity carrier was later unable to meet its obligations, are concerned about annuity portability from plan to plan, and do not perceive much participant demand. While some regulatory changes have lessened these concerns, much more remains to be done before annuities are likely to

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[8] LIMRA (2018).

[9] Benartzi and Shu (2019).

[10] Illanes and Padi (2019).

[11] Lockwood (2012).

[12] Shu, Zeithammer, and Payne (2018).

be considered by a high percentage of plan sponsors. Our companion paper (Iwry et al. 2019) discusses these barriers and possible ways to reduce them.

Given all the obstacles to expanding annuity participation, including the ultimate difficulty of persuading large numbers of individuals to overcome behavioral inhibitions and convert even a portion of their account balance to an income annuity, non-annuity products merit attention as a vehicle for providing retirement security.

A full guarantee against any investment risk may not be essential for all retirees. Some would be comfortable with an investment that offers a high probability of receiving a somewhat higher target level of income for life and a small probability of receiving less. Others will want the security provided by an annuity or a combination of equally safe non-annuity financial products, such as a series or "ladder" of very low-risk bonds, to replicate a somewhat similar outcome. The annuity might be more costly, for example, because of commissions, fees, or other investment expenses, or less costly because of its ability to pool longevity risk to generate mortality credits.

To help determine which approach best meets a retiree's needs, Pfau and Cooper (2014) describe two fundamentally different approaches to thinking about retirement income that might be viewed as defining the opposite ends of the spectrum of preferences (Table 1).[13] What they call the "probability-based" school has goals similar to those of the accumulation phase in seeking to maximize risk-adjusted returns from the total portfolio in accordance with modern portfolio theory. Probability-based retirees tend not to base their retirement planning on a distinction between essential needs and discretionary wants, but instead look at ways to meet their total budget. Their investment portfolio during retirement balances market risk against the probability that the money will run out prematurely. This usually requires a high concentration of equities.

By contrast, Pfau and Cooper's (2014) "safety-first" approach engages in asset-liability matching, or financing different income uses with different assets. For example, consumption of necessities would be financed from an annuity or largely riskless portfolio, while less essential goals could be financed with higher-risk investments. This school tends to believe that retirees must develop a strategy that will at least meet their essential needs (as opposed to desires or preferences), no matter how long they live or how their investments perform.

This discussion is useful in thinking about default mechanisms that would convert retirement savings into income. While the safety-first school appears to prefer an annuity of some size, its adherents are also most likely to be actively involved in structuring a retirement income solution that meets its more specific set of priorities. Thus, it appears that this group would be more likely to move beyond a default solution, probably by moving either some or all of its savings out of the default and into a different arrangement.

On the other hand, the probability-based school, which focuses mainly on aggregate retirement income and is more flexible, would be better served by a default that provides some level of immediate retirement income while still allowing retirees to make other arrangements if their circumstances change. As long as there is an appropriate level of disclosure, an automatic retirement income solution that is flexible and focuses on overall income levels would meet the needs of the probability-based approach, while still allowing

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[13] Pfau and Cooper (2014).

the safety-first school the ability to opt for other alternatives (perhaps, for example, an annuity covering essential expenses plus other investments to finance other expenses or goals).

III. Managed Payout Funds: A Brief Overview

A major alternative to an annuity is a managed payout fund, a diversified pool of investments that is designed to produce a relatively consistent level of annual income but that does not guarantee that outcome.

Managed payout funds are similar in some respects to Target Date Funds (TDFs) but have a different objective. TDFs typically invest in a mix of asset classes, including diversified equities, bonds, etc., designed to build retirement assets. While some TDFs are actively managed, TDFs increasingly use some level of passive index funds to reduce costs. As the investor ages, the fund generally continues to seek maximum growth, but the proportion of the balance held in risky assets falls. Distributing income is not necessarily an objective.[14]

In contrast, managed payout funds serve as decumulation vehicles, paying monthly or quarterly cash distributions to retirees. Their investment strategy generally is designed to generate regular investment earnings and gains for income with carefully managed risk to reduce losses. The goal is stable income payouts stemming from consistent investment returns, and possibly growth, over time rather than maximum gains. The annual income amounts are calculated using both investment performance and, in the case of many managed payout funds, a gradual distribution of the principal amount invested in the fund. Certain other managed payout funds seek to preserve capital, though they have authority to distribute it if needed to maintain targeted payments, and therefore try to fund their targeted payments solely with investment returns.

Typically, managed payout funds are actively managed investment vehicles with at least initially a fairly high allocation to equities combined with countercyclical alternative investments or strategies intended to reduce losses when the markets are down.[15] Although the investments are actively traded, the size of the pool and a legal structure that imposes a fiduciary requirement on management help keep administrative costs low. The funds could also use other investment strategies to achieve these goals, including gradually de-risking the portfolio and combining the phased withdrawal fund with other types of retirement income products.

While these funds are designed to produce level monthly income throughout a given year, that income is likely to vary somewhat from year to year, increasing when markets

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[14] Certain TDFs could be structured to both provide maximum returns before retirement and a relatively stable amount of income during retirement. However, this is not the primary objective of most TDFs, and to avoid confusion, we use the term "managed payout funds" when discussing funds that provide retirement income.

[15] These countercyclical strategies could include investments in real estate, commodities, the use of derivatives, de-risking the portfolio over time through bond investments, etc. The choice will depend on the strategy of the managed payout fund and conditions in the financial markets.

rise and dropping when they decline. To limit variation in income amounts, managed payout funds can use smoothing mechanisms such as reserve funds that spread investment gains and losses over several years.

In proposing such a pooled investment for Canadians, Ryerson University professor Bonnie-Jeanne MacDonald noted that:

> "Not only do pension plans offer a safer way to turn retirement savings into lifetime pensions, but they also have greater investment power – meaning the amount of money you get is much higher than you could likely achieve on your own. Pension plan members pay significantly reduced fees for asset management and administration compared with what is available on the retail market, and they generally achieve higher investments returns (owing to economies of scale, better asset purchasing power and better capacity to diversify investments, across asset classes and over time). Left to their own devices, people tend to be overly conservative or aggressive in their investment choices, without the added investment return for taking that risk."[16]

The largest managed payout fund in the United States, the Vanguard Managed Payout Fund, accounts for almost half of the $3.5 billion in pooled managed payout investment funds held in the country in 2017. All of those funds are retail offerings; managed payout funds that are part of an employer sponsored retirement plan generally would be much larger.

The Vanguard fund holds a portfolio that is about 55 percent in stocks, 6 percent in bonds, 21 percent in commodities, and 18 percent in alternatives such as hedge funds, private equity, etc. Over time, the fund expects to pay investors an annual amount equal to about four percent of their assets, but this may vary depending on the returns on its investments. The fund sets a target level of income every year and then pays that amount in 12 equal monthly payments, while charging a fee of 34 basis points on a minimum investment of $25,000.[17]

Other similar funds exist in the United States, although they are very small.[18] Some are extensions of TDFs where the investment strategy shifts from accumulation to income. Various funds have differing target annual income amounts, such as 4 percent of invested assets over the life of the investment for some or 5.4 percent over 20 years for Fidelity. A similar product using exchange traded funds (ETFs) is being developed to allow investors to benefit from market increases while limiting potential losses.[19]

Shell Netherlands uses a managed payout fund for employees hired after July 1, 2013.[20] While participants have individual accumulation accounts during their working lives, starting about ten years before retirement, their investments transfer to the managed payout fund over roughly ten years. At retirement, the employee can choose variable benefits or use the money to purchase a fixed annuity in the private market. Almost all choose the

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[16] MacDonald (2019)

[17] Vanguard (2019).

[18] Pechter (2017).

[19] Pechter (2018).

[20] Preesman (2019).

variable benefit. The Shell pool has about 35 percent of assets in equities and smooths both investment and longevity risks over a five-year period.

Pooled investment trusts are under consideration in several other countries as well under a variety of names. While the details vary, the basic structure is essentially the same.

The United Kingdom's National Employment Savings Trust (NEST) has a proposal for its members that would combine (1) a managed payout pool, (2) the ability to take partial lump sum payouts, and (3) protection against longevity risk. Under the NEST proposal, initially 90 percent of a saver's retirement assets would go into a managed payout pool and 10 percent would be available for lump-sum payouts to help with financial emergencies or other purposes.[21]

The pool would make monthly income payouts roughly between ages 65 to 85. During those years, portfolio investments would be designed to produce income and protect against both investment and inflation risk. NEST proposes to sell futures contracts at times of increased market volatility and to seek to balance fund payouts with income from property investments and dividends. Inflation risk would largely be handled by inflation adjustments to retirees' state pension payments as well as higher returns from property and equities.

During the managed payout years, about 1.5 to 2 percent of assets would be transferred each year to a separate fund designed to provide income after age 85. NEST considers U.S. QLAC-style[22] longevity annuities to be a promising way to provide stable cash payments for life. Regardless of what form of deferred annuity is used, the actual purchase would not be made until (and unless) the retiree has reached age 75.

Australia is actively developing a retirement income framework called Comprehensive Income Products for Retirees (CIPR) that must be offered as an option, although not necessarily as a default option, to all retirees starting in 2022. CIPRs would use the same basic three parts contained in the NEST proposal. Legislation creating the regulatory structure for the pools is expected to be considered during 2019, and the government proposes to allow Super fund trustees to design specific products that meet this regulatory framework.

Collective Defined Contribution Plans (CDCs) (also known as "defined ambition plans") offer another promising way to employ a pooled managed payout approach. CDCs, which currently exist in the Netherlands, Denmark, and Canada, and are being considered in the United Kingdom in the form of multiple-employer plans, use a single large pooled fund for both the accumulation of balances and the payment of retirement benefits.[23] Benefits are paid in the form of regular pension income. Specific benefit levels are targeted, but they are not guaranteed because benefits are based on the fund's performance and individual's income and contributions. Thus, both contribution rates and retirement income payments could vary depending on how actual investment returns affect the ability to pay promised benefits.[24] The fund would invest in a broadly diversified pool, similar to the

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[21] National Employment Savings Trust (2015).

[22] To help encourage DC plans and IRAs to provide lifetime income, the U.S. Treasury Department and IRS in 2014 authorized "qualifying longevity annuity contracts" (QLACs). QLACs are longevity income annuities for DC plans and IRAs that may begin payments as late as age 85 and that are subject to other conditions designed to promote simplicity and transparency and to facilitate product and price comparisons (U.S. Department of the Treasury 2014; Internal Revenue Service 2014).

[23] Department for Work and Pensions (2019). A handful of such plans exist in the United States as well.

[24] Wilkinson (2018).

pools discussed earlier, except that retirement payments would provide roughly the same replacement rate of pre-retirement income for all participants rather than being calculated individually. Investing is done collectively and professionally and therefore is not self-directed by each individual participant as in 401(k) plans. The multi-generational investment pool seeks to smooth variable investment returns over several years, thus reducing at least some of the potential volatility.

A variation on this plan design would guarantee a minimum pension benefit, as a DB plan does, but would target higher, nonguaranteed benefits. A key challenge facing CDC plans of all types generally is how to ensure that participants understand that the targeted benefits are not guaranteed and that they accept the risk of permanent shortfalls without seeking to hold the plan accountable for inherent volatility and uncertainty in market performance.

IV. An Automatic Retirement Income Option for American Savers

Defined contribution (DC) plans will not fulfill their potential to deliver retirement security until they include an automatic mechanism that efficiently helps participants to convert retirement savings into income. Experience has demonstrated that most new retirees who are handed a lump sum are ill equipped to understand and successfully navigate the many complex risks, tradeoffs, and necessary decisions.

This is where automatic features can have a dramatic effect on helping participants to best use their retirement assets. As first shown in research by Madrian and Shea (2001) and Thaler and Benartzi (2004), automatic enrollment and automatic escalation in 401(k) plans has proven to be an effective and popular way to guide people to appropriate retirement saving decisions.

The same kind of automatic guidance that has helped millions to build retirement assets could plausibly have a similar dramatic effect helping them to use those savings effectively.

Because it is not mandatory, an automatic income mechanism does not need to – and could not – provide a perfect solution to every retiree. It should, however, provide significant value to the largest number of retirees possible. To meet this goal, we believe that the mechanism should meet several standards:

- It should be simple, transparent, and inexpensive.
- It should protect against the risk of outliving one's savings and provide regular lifetime income that is reasonably stable over time.[25]
- It should be reasonably protected against sequence of returns, market, and inflation risks.
- It should be flexible enough to allow the retiree to change course and pursue a different income strategy without causing undue adverse selection.

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[25] Another goal of the default would be to include spousal protections.

- It should provide sufficient liquidity and flexibility to permit a separate fund that allows retirees to make lump sum withdrawals for emergencies or other purposes without unduly disrupting their regular retirement income.

Several strategies could meet one or more but not all of these standards. For example, purchasing an annuity would provide stable lifetime income but would be inflexible, and could also generate high and obscure fees.[26] Similarly, leaving the retirement savings in an employer plan and withdrawing a fixed amount at regular intervals would be simple but would fail to manage the longevity risk, the sequence of returns risk, the market risk, and the risk of paying higher fees than necessary. These alternatives may be the best choice for some retirees, but they would not work as default income mechanisms.

We propose that the automatic retirement income mechanism contain three features. In addition, we strongly urge employers to assist participants with the timing of their Social Security benefits. While this element would not be part of a default income strategy, the two together will enable participants to optimize their total retirement income. The three elements of the automatic mechanism would be:

- A pooled managed payout fund;
- A fund from which retirees could withdraw partial lump sums for emergencies or other special purposes; and
- A QLAC-type longevity annuity.[27]

This structure is similar to proposals in the U.K. and Australia described in the Appendix. At the time of the transition from savings to income, retirement assets would be divided into the three components. Most of the money would go into a managed payout fund. Approximately 10 percent would be set aside for emergencies or other lump sum withdrawals and placed in a liquid investment or even a bank account. The remainder would be earmarked for the purchase of a QLAC-style longevity annuity that would begin payments at about age 85.

Since most individuals will not have all of their retirement savings in one account, the managed payout fund would be designed also to accept money from the plans of past employers, rollover IRAs, as well as IRAs the individual started on their own. Ideally, an individual's assets from all these sources would be combined and managed as a whole in a managed payout fund, QLAC and emergency fund. Hopefully, these packages will also be established on a multiple-employer basis, with the fund making transfers, rollovers, and consolidations as simple and easy as possible. In addition, the fund would be structured to provide income from both Roth and traditional accounts through internal subdivisions.

The managed payout fund could be structured with a similar asset mixture and income goals as existing retail funds and the Shell Netherlands fund. It would be designed to produce a regular stream of retirement income equal to roughly a set percentage of the indi-

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[26] However, negotiation of a group purchase by plan officials on behalf of participants might achieve institutional pricing and address this problem.

[27] The QLAC's deferral of RMD liability would be an additional advantage but would not apply if the longevity annuity exceeded the applicable QLAC dollar and percentage limits. If a larger amount was desired, the annuity would be treated as a non-QLAC longevity annuity, which would not enjoy the special RMD treatment.

vidual retiree's fund balance based on both investment performance and a gradual distribution of the initial investment, although this amount would not be guaranteed. Because the fund would include significant investments in equities and other growth investments, it should be able to pay out a higher income level on average than if it was invested solely in bonds or safer assets.

The actual payment amount would be set annually based on the performance of the investments in a preceding period or periods. To reduce fluctuations in payment levels, the fund would include counter-cyclical investments intended to hold down losses during market declines. In addition, income could be smoothed by multi-year averaging or by using a reserve account to retain some investment income during high-return years that could be used to offset lean years.

Once payments begin, the retiree would receive a regular monthly check, a feature that could easily be provided by most existing recordkeepers.[28] Payments would be designed to also satisfy any federal required minimum distributions (RMDs) that apply to the retiree.

The separate emergency fund is an essential part of the package. Studies by the JP Morgan Chase Institute show that older households are more likely to have extraordinary expenditures for healthcare, auto repair, and taxes than younger families.[29] Having a separate fund for these emergencies and other occasional necessary withdrawals will make it easier to meet these eventualities.

The QLAC (which could be a joint and survivor annuity for the retiree and a spouse or other beneficiary, or a single life annuity) would continue payments for life and would serve as a safety net to ensure that retirees cannot outlive their savings. As such, it would be packaged with the overall mechanism. The QLAC's guarantee of lifetime income starting at age 85 (or at an earlier age if the participant so chooses) would enable the managed payout fund to be managed to produce regular income across a finite time horizon instead of trying to plan drawdowns over an uncertain life span. It is not essential, however, that the actual purchase of the QLAC be made upon retirement. Retirees could request a delay of up to several years in order to decide whether a different retirement income option better suits their needs.[30]

In addition, we recommend that retirement savings plans offer lifetime annuities as an optional choice – including annuities that are limited to a portion of the account balance intended roughly to fund essential expenses – as well as other retirement income options that participants could use instead.

This structure meets all of the standards proposed above. It is simple to explain. Appropriately managed and regulated, the plan would generate low costs. The proposal is structured to provide income for life through the longevity annuity as well as predictable, regular income and money available for emergencies. Investments through the managed payout fund will also help to protect retirees against inflation, while the separate fund could be drawn upon to help protect against sequence of returns risk. It is also flexible enough to

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[28] Certain managed payout funds might be structured so that a participant's entire savings are consumed by the time that the QLAC starts to make payments. Others might allow retirees to have an amount remaining at that time to use for bequests or to transfer into the emergency fund.

[29] Farrell and Greig (2017).

[30] As rates for a longevity annuity depend on the age at which the contract is bought, such a delay is likely to increase the price of the annuity. In addition, if a significant number delay or fail to purchase a longevity annuity, adverse selection may result in overall higher rates for this product.

allow for both different circumstances and different retirement income choices. If some participants wish to use a different retirement income strategy, they only need to opt out of the default in much the same way that someone whose savings are automatically enrolled into a TDF can opt out and choose another investment.

At least initially, this automatic retirement income solution would be provided through employer-sponsored and similar plans.[31] Thus, the transfer into a managed payout fund and the other elements of the mechanism would be handled by the plan, not outside of it. In time, however, financial institutions and plan service providers might be expected to relieve plan sponsors of many of these responsibilities.[32]

As part of an employer plan, the managed payout funds do not need to be part of a TDF or other type of accumulation vehicle, although they could be structured to grow organically out of a TDF at retirement, with a shift in objectives to include the regular payouts. They would be a separate fund in which an individual saver is automatically enrolled as of a certain date, with the transfer either spread out over a number of years or all at once. The transfer would not be irreversible. If the employee changes jobs during the transition, the money could be rolled into the new employer's plan. Similarly, the participant could change his or her mind and decide on a different retirement income strategy either before retirement or even after payments begin.

Ideally, the funds could serve many different employers to achieve even greater economies of scale instead of being limited to one employer. Just as employer plans typically use pre-existing investment options such as mutual funds during the savings phase, the payout funds could manage the retirement assets from many retirement plans. Since the funds are designed to provide retirement income for roughly 20 years and plan sponsors would be reluctant to have a fiduciary responsibility for a period that long, we propose that Congress and the regulators take appropriate steps to meet plan sponsor concerns, while still protecting participants. There are a number of ways these goals could be accomplished, but the discussion is beyond the scope of this paper.

The proposal focuses on participants in employer-sponsored retirement savings plans. A similar design could be used for IRAs in the retail market, which, through rollovers, continue to accumulate an increasing share of retirement assets. The retail solutions would contain the same three elements and options, and they could even use the same managed payout funds as the employer plans do. To increase the availability and potential use of these options in the retail market, it may be helpful, at least in the near future, to consider ways to make them more attractive to financial advisors. If feasible, this might involve appropriate, unconflicted, and reasonable compensation for advisors who might receive commissions financed by a portion of fees charged during the payout phase. Over time, this retirement income mechanism could become an integral feature of individual savings products such as IRAs.

However, before some plans can offer an automatic retirement income option, they need to take other preliminary steps. Unfortunately, many 401(k) plans do not provide for payouts other than lump sum distributions – sometimes only allowing a single lump sum

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[31] For instance, state-facilitated retirement savings programs might eventually use the retirement income mechanism once account balances reach a size that would make this efficient. New types of plans designed to meet the needs of contingent workers could also possibly use it.

[32] In addition, we encourage financial institutions and plan service providers to facilitate the offering of in-plan or out-of-plan annuity bidding platforms or another type of platform presenting a menu of lifetime income options.

distribution of the entire balance – and RMDs. This unnecessarily restrains participants' ability to take advantage of retirement income strategies and to draw benefits in a manner that suits their needs, including the ability to meet emergencies or for other purposes. We recommend that all 401(k) and other DC plan sponsors review their documents to determine whether plan amendments are needed to enable participants to receive their benefits in a more flexible way through periodic or other withdrawals – including annuities, installment or other managed payouts, other systematic and regular income, or ad hoc withdrawals made from time to time.

In addition, the regulatory situation needs to be clarified. Currently, the applicable Labor Department regulations do not classify most lifetime income vehicles, including annuities and managed payout funds, as Qualified Default Investment Alternatives (QDIAs) that DC plans can offer on an automatic or default basis without concern about losing safe harbor protection from potential liability under ERISA.[33] Certain annuity contracts and related features and certain managed payout funds would or might also qualify as QDIAs. However, many would not, and in other cases, the answer is unclear and would benefit from regulatory or legislative clarification. We therefore urge the Department of Labor to amend its regulations so that plans could confidently offer appropriate income annuity contracts, managed payout funds, and certain other retirement income investment vehicles on an automatic basis. This action would mirror the way that plan fiduciaries were earlier given a measure of protection, so they could confidently offer target date funds and certain other investments as default investments.

In addition to the automatic retirement income mechanism, we propose that plan sponsors and others take a fundamental prior step in promoting retirement income.[34] Employees approaching age 60 should receive information and counseling on the related set of basic choices regarding future work options, when to start Social Security benefits, and when to start drawing retirement plan or IRA benefits. Among other things, plans could connect participants to video and written explanations prepared by the Social Security Administration and other appropriate sources regarding the potential advantages to many individuals of, in effect, "buying" a meaningful additional amount of secure, guaranteed, inflation-indexed, lifetime Social Security income by delaying the start of their Social Security benefits. This might involve working longer and/or drawing on plan or IRA savings to be able to postpone Social Security commencement and increase the monthly benefit.

V. Conclusion

Choosing the best way to convert retirement savings into a stream of income is one of the most complex financial decisions individuals have to make. It is increasingly clear that

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[33] ERISA section 404(c)(5). But see Borzi (2014). QDIA protection is not the only path, however. Plan fiduciaries can make their own judgments that such default options would satisfy their ERISA duties of prudence and loyalty. See, e.g., Campagna (2016). Alternatively, plan fiduciaries can prudently engage and monitor an investment manager or other independent fiduciary to assume fiduciary responsibility for such a retirement income arrangement. Ultimately, if responsible financial providers have sufficient interest and capacity, and if appropriate regulation can be achieved, this may hold the most promise, especially for mid-market and smaller DC plans.

[34] To the extent necessary, the Department of Labor should facilitate this type of guidance by issuing regulations enabling employers to offer this service without fearing that it will be considered as investment advice or expose them to liability.

expecting most retirees to make informed decisions about these choices is optimistic without sufficient guidance. As the U.K.'s NEST pointed out, "Research has shown that even the most financially capable individuals can make irrational and sub-optimal choices when it comes to financial matters, or defer making those choices out of regret aversion."[35]

Ideally, individuals would choose a retirement income program based on timely pre-retirement education, appropriate robo-advice, and individual counseling, although there are not enough unbiased and qualified financial planners available to meet the need. Inevitably, therefore, guidance in the form of behaviorally-informed choice architecture will need to play a key role.

Any effort to develop default options, though, must recognize that optimal retirement choices are heterogenous. Individual circumstances vary, and a one-size-fits-all solution will be less than ideal for many. Similarly, retirement income options will undoubtedly continue to evolve and improve over time. For these reasons, any automatic or other retirement income strategy should be re-examined regularly to ensure that savers have the best available solutions.

Gale et al. (2008) proposed an automatic trial annuity, where a portion of an individual's retirement assets would be placed into such an annuity for two years, after which he or she could either leave it in the annuity or take the balance and use it differently.[36] The goal was to help new retirees see and experience their savings as a lifetime income stream rather than as a lump sum. In certain circumstances, the trial annuity would still be an appropriate, and even optimal, solution, but as explained above, there are other valid ways to convert savings into income. Some of them still feature an annuity, but often it is a deferred longevity annuity rather than an immediate lifetime annuity. Retirees will be best served by income choices that are not limited to just the same approaches and products that were tried in the past.

In our view, as discussed above, the right goal should be for retirement savings plans to offer automatic mechanisms that would make it easy for participants to convert saving balances into income. Properly structured and regulated, automatic retirement income structures could help new retirees in much the same way that automatic enrollment and escalation help savers.

As noted, a particular automatic mechanism we recommend is that plans should offer a pooled managed payout fund, a QLAC longevity annuity, and an amount for emergencies and special expenditures. This structure is flexible enough to allow participants to make changes during retirement as their circumstances evolve. In addition, we recommend that plans offer lifetime income annuities as an optional choice. For many people, acquiring an appropriately consumer protective and reasonably priced income annuity with at least a portion of their savings will still be the best choice for retirement income, and for many others it will play a key role in a broader post-retirement financial strategy.

Retirees need innovative solutions that help them make the best use of their savings as they transition to a new phase of life. Guidance, in the form of an automatic choice, is needed to help them make appropriate decisions. While there are many specifics to work out, we believe that the combination of features discussed above offers a new, sensible, and sound approach to providing income security in retirement.

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[35] National Employment Savings Trust (2015).

[36] Gale et al. (2008).

Appendix. The International Debate about Retirement Income

This appendix briefly considers policy discussions and proposals in Australia, the United Kingdom, New Zealand, and Canada.

Australia

Australia's retirement income debate is one of the more sophisticated. The country's retirement system combines a means-tested government pension and a defined contribution Superannuation program in which employers are required to contribute 9.5 percent of wages to an account for their employees.[37] While the Superannuation system provides retirement income for a growing number of Australians, there are increasing problems with asset decumulation. Most Australians withdraw their retirement assets either in a lump sum or by taking out regular streams of income. While the accounts are subject to required annual minimum withdrawals, there is no protection against longevity risk.

Recognizing this growing problem, the 2014 Financial System Inquiry, known as the Murray Inquiry after its chairman, called for the creation of Comprehensive Income Products for Retirement (CIPR), which would be offered to all retirees.[38] A CIPR would be a composite retirement income product with several elements that the inquiry estimated could provide a retiree with an income that could be 15 to 30 percent higher than would be available otherwise.[39] However, the inquiry did not define what a CIPR would look like, recognizing that there could be a number of combinations that could achieve these goals.

In 2016, the government published a proposed framework for the CIPR, setting out a framework for the product, explaining how the trustees of Superannuation funds should offer the program to savers and how the CIPR should be regulated.[40] The framework proposed that a CIPR provide at least a minimum level of income that would exceed the amount that would be available using just a drawdown of saving, a roughly stable lifetime income level, and access to part of the savings in a lump sum if desired. It asked for comments on how to accomplish these goals. The framework is open about what mechanism would best achieve these goals, and it noted that the proposal was not intended to promote annuities over other types of products, impose a choice on savers, or replace the need for financial advice.

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[37] Starting in 2021, the amount employers are required to contribute to the account will gradually rise until it reaches 12 percent of wages in 2025.

[38] Murray et al. (2014).

[39] In 2017, the government decided to call a CIPR "MyRetirement products," but later consultation papers continue to use the term CIPR (Australian Treasury 2017).

[40] Australian Treasury (2016).

A further position paper in May 2018 requested comments about the government's proposed retirement income covenant that would specify how fund trustees should structure a CIPR, present it to its members, and remove regulatory barriers.[41] It noted that while there is broad agreement about the need for a CIPR, there is a great deal of disagreement about how it should be structured. The paper called for reporting Superannuation balances as retirement income rather than lump sums (somewhat similar to legislative proposals in the United States referred to in our companion paper on regulatory solutions to encourage annuities). It also noted that a CIPR should "incorporate any one (or more) of a range of pooled lifetime income products (either immediate or deferred), such as a group self-annuitization product or a guaranteed lifetime annuity."

This occurs against a backdrop of a limited Australian annuity market. The regulatory system in Australia prohibits deferred and variable annuities since annuity vehicles are required to provide fixed payments. This restriction has created political pressure to expand access to annuities in order to make the annuity market more competitive, and to explore alternatives. As a result, there have been proposals for longevity insurance programs that provide an account-based option to increase flexibility.[42] Some variation of these proposals is expected to be adopted.

A key question is how an annuity feature in a CIPR would be counted for Australia's means-tested government-paid pension. Under government legislation that may be approved in the near future, "a fixed 60 percent of all lifetime product payments will be assessed as income for age pension eligibility, and 60 percent of the purchase price will be assessed as assets, reducing to 30 percent from the later of age 84 or five years after purchase."[43] The government proposes to legislate the CIPR covenant by July 1, 2019 to go into effect a year later. However, Superannuation funds will not be required to offer a CIPR until July 1, 2022.[44]

The United Kingdom

The retirement income debate in the United Kingdom for retirement savings plans has moved from a mandatory annuity purchase to recognition that some default strategy to convert savings into income is needed. Prior to April 2015, most U.K. retirement savers were required to convert 75 percent of their savings into an annuity. Although several tools were available that allowed savers to compare the income they would receive from various providers, most simply purchased an annuity from the same entity that had handled their account before they retired. If the amount of savings was fairly small, the regular annuity income was tiny, a problem that became even more acute when interest rates declined after the 2008 financial crisis and stayed low.[45] However, as a result of the 2012 Automatic Enrolment reforms that created a universal retirement savings system (including mandatory

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[41] Australian Treasury (2018).

[42] Lee (2017).

[43] Mather and Cleveland (2018).

[44] Fry (2019).

[45] Work and Pensions Committee (2018).

employer contributions) that would cover almost all workers in the United Kingdom, future retirees were expected to have significant amounts of savings that could supplement their state pensions.

In April 2015, the U.K. Treasury announced a new policy under which anyone over the age of 55 could access any or all of their retirement savings.[46] At the same time, the mandatory annuity purchase requirement was abolished. Those who chose to withdraw retirement assets could take 25 percent of the total tax free and pay tax on the remainder at their normal income tax rates. As a result of the removal of the annuity requirement, the Work and Pensions Committee in the House of Commons found that only 5 percent of new retirees at one major provider bought an annuity, while 53 percent chose to draw down their savings.[47]

A regulator found that 94 percent of those withdrawing retirement savings also had other income such as defined benefit pensions, and that many people were not simply spending the money.[48] However, there is growing concern about the future. The Work and Pensions Committee noted that while the automatic enrollment used to increase retirement saving depended on consumer inertia, the withdrawal options enabled by the pensions freedoms required savers to make active, informed choices. Most withdrawals have been taken without the saver receiving any professional guidance. As more people come to depend on a combination of the state pension and savings for retirement income, uninformed decisions could cause retirees to run out of money.

As a result, the Committee suggested that the government require plan sponsors to provide account holders with a default drawdown strategy beginning in April 2019 that could allow annuities as part of the overall program. This would protect retirees' savings and encourage plan sponsors to aid with decumulation.[49] The government has yet to act on the recommendation.

One approach was suggested by the National Employment Savings Trust (NEST).[50] As NEST serves many lower-income savers, its proposal is considered suitable for a general population. It recognizes that needs change as the retiree ages, and it combines a drawdown from an actively managed account with a cash account for unforeseen needs and the possibility of a longevity annuity that starts at about age 85.[51] NEST stresses that unlike automatic default options during the accumulation process, this mechanism may not be appropriate for decumulation. As a result, their proposal would be a recommendation and would not necessarily become a default option. The NEST proposal is discussed in more detail in an earlier section of this paper.

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[46] The U.K. allows people to access their savings before the age of 55 only in exceptional circumstances.

[47] Work and Pensions Committee (2018).

[48] Financial Conduct Authority (2017)

[49] Pielichata (2018).

[50] NEST is a trust-based DC pension provider that U.K. employers can use to meet the new workplace pension duties set out in the Pensions Act 2008. NEST is designed to be an easy-to-use, low-charge scheme. It was set-up by government and must accept all employers that want to use it to comply with their duties.

[51] National Employment Savings Trust (2015).

New Zealand

New Zealand has a unique retirement system that includes a residency-based pension paid by the government and a universal, automatically enrolled retirement savings system designed to supplement the government-paid income. New Zealand Superannuation pays a flat-rate amount to individuals who have lived in the country for at least a certain length of time regardless of need or any alternate source of income.[52] KiwiSaver, an automatic enrollment retirement savings plan, is intended to provide retirement income above that amount. Unfortunately, KiwiSaver balances are far too low, and the program is also used to save for a down-payment for housing, which further depletes potential retirement assets.

Financed in part by KiwiSaver, many New Zealanders invest in real estate, with the idea that the equity released from the sale of the house upon retirement will finance the gap between the government benefit and their current standard of living. Unfortunately, this money actually tends to last only a few years.[53] While many of the problems could be mitigated by increasing the amount saved in KiwiSaver and improving investment outcomes, the system still leaves retirees exposed to longevity risk.

For the most part, annuities do not exist in New Zealand. In 2009, the only remaining annuity provider in the country sold a grand total of 17 contracts.[54] However, there is increasing attention to the need for better retirement income outcomes.

In a report submitted to the government, Susan St. John, director of the Retirement Policy and Research Centre at the University of Auckland, recommended creating a "limited-value generic annuity with generic branding, with oversight by FMA (the regulator), and default provisions."[55] She believes that KiwiSaver should default savers into an annuity and provide an opt-out option. The annuity should be gender-neutral, have low cost administration, and protect retirees from inflation. Benefits could be linked to average wages or average investment returns, and there could be an option for long-term care insurance. In lieu of tax incentives, the annuity program could include decumulation subsidies that would be limited by an overall annuity size cap.

So far, the government has not acted, but as KiwiSaver balances grow, the need for stable retirement income is causing a revival of interest in retirement income strategies in New Zealand.[56]

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[52] New Zealand annual Superannuation payments are about $13,000 (U.S.) for a single person and $20,000 (U.S.) for a couple. For details, see Ministry of Social Development (2019).

[53] Financial Services Council (2018).

[54] St. John (2009).

[55] St. John (2018, page 2).

[56] Good Returns TV (2018).

Canada

The Canadian government's 2019 budget released on March 19, 2019 proposed to create both longevity annuities and tontines[57] – although both under different names. An Advanced Life Deferred Annuity (ALDA) must start payments at age 85. Savers can use up to 25 percent of the assets in a plan to purchase them, with the purchase price being subtracted from mandatory withdrawal calculations.[58]

In addition, the budget proposed the creation of a Variable Payment Life Annuity (VPLA), which would be offered through a retirement plan with a minimum of ten participants. A VPLA would provide payments that depend on both the performance of investments in the pool and the participants' mortality.[59]

The Canadian budget provisions followed a 2017 Association of Canadian Pension Management study on asset decumulation, which suggested that the country develop multi-employer retirement plans that are risk-pooled and provide default investment options. This would encourage the development of solutions to draw down assets that are part of the plan rather than requiring employees to see them in the open market. The report concluded that related proposals or programs in other countries "often feature managed withdrawals, provide limited access to lump sums, and permit longevity pooling through deferred annuities."[60]

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[57] A tontine is an asset pool that pays its investors a regular income. In addition, as other tontine investors die, the survivors receive increased income as the pool's earnings are divided among fewer people and perhaps a share of the deceased members' assets.

[58] Burgess (2019).

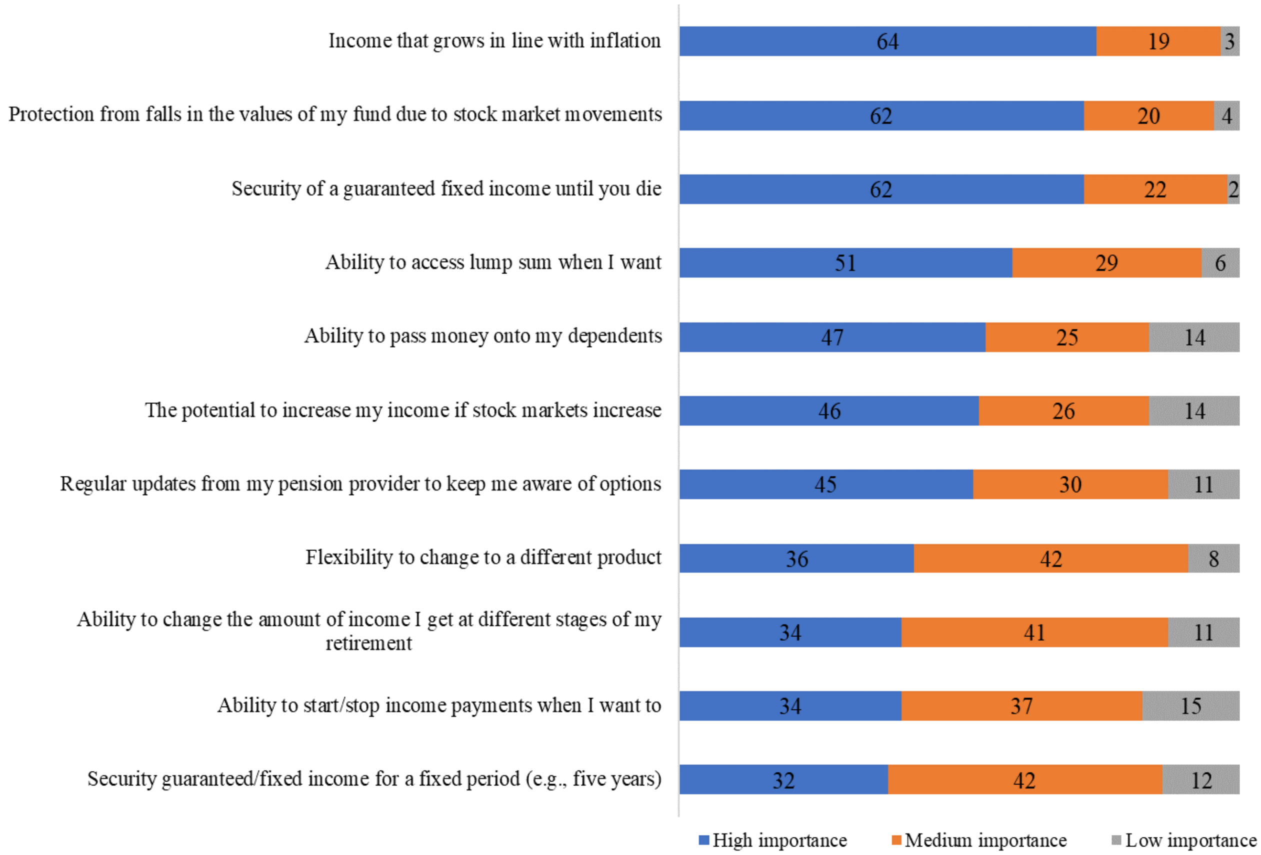
[59] Ernst & Young (2019).

[60] Melnitzer (2018).

[61] Melnitzer (2018).

Figures & Tables

Figure 1. Preferences for Retirement Products Among NEST Customers



Source: National Employment Savings Trust (2015, Figure 3.1)

Table 1. Retirement Income Philosophies

Issue	Probability-Based	Safety-First
How are goals prioritized?	Retirees have a particular lifestyle goal in mind and not meeting this overall goal indicates failure. Lifestyle goals are not prioritized between essentials and discretionary.	Goals are prioritized. For instance, the funding hierarchy could be: (1) basic needs, (2) contingency fund, (3) discretionary expenses, (4) legacy goals.
What is the investment approach?	Usually a total returns perspective framed in the same terms as pre-retirement accumulation using techniques such as portfolio diversification. The focus is wealth management for the financial portfolio.	Asset-liability matching. Assets are matched to goals so that risk levels are comparable. Lifetime spending potential over an uncertain horizon is the focus, not maximizing wealth. There is a wider role for products to hedge interest rate risk and provide longevity insurance.
What is the role of an account-based pension?	The account-based pension is all that is needed for an outcome that will probably work. They are flexible enough to make whatever adjustments are required.	The account-based pension can be utilized after the safety requirements have been met. It can then deliver aspirational or discretionary spending.

Source: Pfau and Cooper (2014)

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