AUTOMATIC LIFETIME INCOME AS A PATH TO RETIREMENT INCOME SECURITY

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ABSTRACT

This paper proposes that policymakers encourage "automatic annuitization" so that it becomes an integral part of defined contribution retirement plan design in the U.S. A large body of research in economics indicates that life annuities are the most cost-effective way to provide guaranteed income that will last for as long as an individual lives and that, as a result, annuities ought to play a central role in the portfolio of most retirees. Unfortunately, for a variety of historical, regulatory and behavioral reasons, most participants in defined contribution plans (such as 401(k) and 403(b) plans) do not currently have access to guaranteed income options through their employer's plan. An emerging body of evidence suggests that making life annuities the "default" payout option from defined contribution retirement plans may be an effective way to increase annuitization rates and therefore an effective way to boost retirement income security of future retirees. The paper discusses a general outline for how such an automatic annuitization program could be implemented so as to increase participant choice, encourage annuitization for the majority of households for whom annuities would enhance retirement security, and limit the administrative burden on plan sponsors.

The views express herein are the views of the author and do not necessarily represent the views of the American Council of Life Insurers or its member companies.

1. INTRODUCTION: RETIREMENT SECURITY REQUIRES MORE THAN WEALTH ACCUMULATION

The recent turmoil in financial markets has reminded workers and retirees that there is more to ensuring a financially secure retirement than simply accumulating a large balance in a 401(k) plan. True retirement security also requires that an individual have a sustainable strategy for converting one's account balance into a guaranteed income stream that will last for life, regardless of how long one lives or how financial markets perform late in life. Life annuities are financial products that provide this service by allowing an individual to convert wealth into guaranteed lifelong income, thus insuring that the retiree (and his or her spouse) will not outlive his or her retirement resources.

In recent decades, the employer-provided retirement system in the U.S. has systematically emphasized wealth accumulation and largely ignored the equally important step of converting this wealth into retirement income. The typical defined contribution (DC) plan that is in place today provides ample opportunities for saving and accumulating wealth, but fails to provide opportunities for participants to purchase annuities. Indeed, by some estimates, only one in five 401(k) plans even offer participants the option to annuitize through the plan. In short, the typical DC plan is an effective savings vehicle but is not a complete or effective vehicle for providing overall retirement income security. It need not be this way: by intelligently designing the post-retirement phase of DC plans to allow participants the ability to convert their wealth into annuitized income, the DC plan of the future can easily become an effective vehicle through which individuals can achieve true retirement income security.

Employer-provided pensions have long played an important role in the U.S. retirement planning landscape. For many decades, defined benefit (DB) plans provided retirement income in the form of an annuity. While participants in DB plans sometimes have alternative distribution options available to them, it has always been the case – and remains so today – that annuitization rates from DB plans vastly exceed annuitization rates in DC plans. Participants who prefer to forego the annuity in a DB plan must proactively opt out of the annuity, and in some cases this requires the retiree to provide a notarized spousal signature in order to forgo annuitized survivor benefits. It is no accident that DB plan sponsors provided benefits in the form of an annuity: providing joint-and-survivor annuity benefits as the default has long been a requirement for DB plans to qualify for tax benefits.

When Congress passed the Revenue Act of 1978, which included the provision that employees are not taxed on elective deferrals of compensation – a provision that went on to become Section 401(k) of the Internal Revenue Code – few policymakers foresaw the tectonic shift in the pension landscape that would result (EBRI, 2005). Over the subsequent three decades, 401(k) plans have become the dominant form of retirement plan in the U.S. Whether measured by number of plans, number of participants, or assets under management, DC plans are now more important than DB plans as a retirement resources for the average household.

The shift from DB to DC has provided numerous benefits to employers (e.g., reduced funding risk, lower administrative costs) and employees (e.g., increased portability, greater investment choice). As 401(k) plans have become the dominant feature of the U.S. retirement landscape, Congress has acted several times to ensure that these plans are designed in a manner that meets various public policy objectives. This includes, for example, requiring "nondiscrimination" tests in order to ensure that plans do not excessively favor highly compensated employees, limiting annual deferrals, setting rollover requirements, providing minimum vesting requirements, and recently, encouraging automatic enrollment and the use of qualified default investments. Most of the aforementioned policy initiatives designed to improve and/or regulate DC plans, however, are focused on the accumulation phase. Congress, like many plan sponsors and participants, has focused primarily on saving and wealth accumulation without paying adequate attention to issues in the withdrawal phase.

Given the unique and important role of annuities in providing lifelong retirement security, the failure of policymakers and plan sponsors to ensure that participants in DC plans have access to annuities has important implications for retiree well-being. Without easy access to annuities, retirees must balance two competing risks that arise from uncertainty about length-of-life. On the one hand, if a retiree consumes her wealth too quickly, she risks outliving her resources and suffering a decline in living standards at advanced ages. If a retiree responds to this risk by consuming too slowly, she must subject herself to a lower level of consumption throughout retirement than is truly necessary. Life annuity products are designed specifically to eliminate the need to trade-off these risks. Annuities convert wealth into guaranteed income that cannot be outlived and that provide a higher level of sustainable consumption than can be achieved by other, alternative distribution options.[1] Because of this, a large body of academic research has illustrated the value of annuities and illustrated that having access to life annuities during retirement can boost overall retiree well-being by as much as a substantial increase in wealth (e.g., Mitchell, et al 1999; Davidoff, et al 2005).

This paper proposes that Congress encourage access to annuities in DC plans, including 401(k) and 403(b) plans, and encourage the use of annuities as the default distribution option. By providing access to annuities, millions of DC plan participants would be given the opportunity to utilize products that are an effective, efficient and appropriate tool for converting retirement wealth into a lifelong income stream. Using annuities as the default distribution option would leverage the insights from behavioral economics about the power of defaults to influence a wide range of behaviors, insights that have, so far, been applied primarily to the accumulation phase of retirement plans. The time has come to apply these insights to the post-retirement withdrawal phase and use plan design to encourage annuitization instead of encouraging individuals to take a lump-sum or other uninsured withdrawal option. An attractive feature of the use of voluntary defaults is that it effectively promotes retirement income security while still preserving the right of the individual participant to make their own choices.

Under an annuity default plan, sponsors would provide an automatic annuitization option as the default distribution policy instead of using a lump-sum withdrawal or an uninsured withdrawal option as the default. Congress could encourage the use of automatic annuitization by reducing the fiduciary burden on employers who seek to provide retirement income security to their participants. If automatic annuitization proves effective at boosting annuitization rates without being unduly burdensome on employers, employers may start voluntarily adopting it as part of their plan design. If automatic annuitization proves effective and employer participation remains low, Congress could subsequently choose to make automatic annuitization part of plan qualification requirements. Either way, automatic annuitization can be achieved through a wide range of specific product offerings, provided that they meet certain minimum requirements related to the amount and timing of annuitization.

Specifically, this proposal suggests that employers be encouraged to adopt an automatic annuitization plan under which, when an employee makes an initial request for a (non-hardship) withdrawal from a DC plan, the employee would be notified that he or she is being automatically enrolled into a (partial) annuitization program.[2] This program would convert half of the participant's total 401(k) account balance into a joint-and-100%-survivor annuity for married couples, or a single life annuity for unmarried individuals. These annuities could be immediate annuities subject to a trial period as suggested by Gale, et al (2008), a series of laddered annuities with payouts that commence over a several-year period after the initial distribution decisions, or various integrated, in-plan annuity options that allow participants to invest in deferred annuity contracts during the accumulation phase. Rather than mandating annuitization as is done in some countries (such as the U.K.), participants in this program would have the opportunity to "opt out" of this program by notifying their employer of their desire to do so, thus preserving individual freedom to choose a payout option that is optimal for the individual.

This paper begins in section 2 with a discussion of the current state of distribution options from DC plans, focusing primarily on the fact that most DC plan participants are not able to access annuities through the plan. It also explores some of the reasons that plan sponsors do not currently offer these income options. In section 3, the paper discusses the available evidence that suggests that an "automatic annuitization" program would likely increase annuitization rates in the U.S. Section 4 proposes some general principles that should guide the development of an auto-annuitization default option. The specific proposal is outlined in section 5. In section 6, a "Q & A" format is used to further explain the details of the proposal. Section 7 provides a discussion of several possible approaches to structuring an automatic annuitization plan. Concluding remarks are provided in section 8.

2. THE CURRENT STATE OF 401(K) PLAN DISTRIBUTION OPTIONS

2.1 Evidence that "Employers Matter"

Decades of research in economics supports the intuitive idea that life annuities are valuable to retirees because they offer the least expensive way to guarantee a stream of income that will last for life.[3] Life annuities are able to achieve this value advantage because the annuitant forgoes the ability to bequeath the assets used to purchase the annuity. As a result, the annuity provider is able to pay a higher rate of return to annuitants, and pay this return for as long as the annuitant lives, than an otherwise similar but non-annuitized asset.[4]

Despite the theoretical and actual benefits of annuitization, most participants in 401(k) and other DC plans simply do not have the option to annuitize through their plan. Instead, the typical plan provides benefits in the form of a lump-sum or a series of non-annuitized withdrawals. In essence, we already have a "default distribution policy" in the U.S., but unfortunately it is one that does not provide guaranteed lifetime income. Given the power of defaults in influencing behavior, it should not be surprising that most DC plan participants take their retirement plan benefits in one of these non-annuitized forms.

In addition to not offering annuities, most plan sponsors do not provide their participants with much information about the importance of guaranteed lifetime income. As noted by the Government Accountability Office (2003, p. 14), employers tend not to be very involved in any aspect of the distribution phase, noting that plan sponsors:

"generally did not provide information on considerations relevant to managing pension and retirement savings plan assets at and during retirement ... plan sponsors generally do not discuss the potential pros and cons of available payout options as related to managing pension assets during retirement ... they typically do not discuss risks retirees may face in managing their assets during retirement or provide information on how to assess needs at or during retirement."

Some will no doubt argue that individuals are free to purchase annuities using their DC account balances by withdrawing the money from the DC plan and rolling it over into a tax-qualified annuity contract. This is true, but it is worth considering what is involved. The individual must understand the value of annuities, despite receiving limited or no information about annuities from their employer. The participant must not be dissuaded by the implicit endorsement of the lump-sum or other non-annuitized withdrawal option that their plan sponsor chose as an implicit default and must overcome the status quo bias and other powerful behavioral impulses that often prevent individuals from following through on their plan. The individual must then select an annuity provider from a large universe of insurance companies, navigate the often complex and confusing array of products that include the term "annuity" in their name despite not offering lifetime income, and then select from a broad range of product features and options. Having done this, the individual can then purchase the annuity in an individual market, which, because it currently consists of a self-selected group of individuals who empirically have lower mortality rates than the general population, likely provides lower annuity payments per dollar of premium than annuities purchased through an employer.[5]

Successful navigation of these steps, and even the initial motivation to try, requires at least some semblance of financial literacy. While neoclassical economics models often assume perfectly informed and rational consumers, a growing body of empirical work in economics has documented that very substantial portions of the population are financially illiterate, and that this financial illiteracy has important implications for individuals' abilities to make effective financial planning decisions with regard to retirement (see, e.g., Lusardi and Mitchell 2007a and 2007b). This remains true even when one restricts the analysis to participants in 401(k) plans (John Hancock Financial Services, 2002).

In addition to low levels of financial literacy, a growing body of research suggests that the psychological biases that individuals bring to financial decision-making may keep consumer demand for annuities lower than optimal levels. For example, recent research has shown that when alternative financial products are presented in a context, or "frame," that emphasizes consumption, individuals are substantially more likely to express a preference for annuities than when the same product information is provided in a frame that emphasizes investment features (Brown, et al, 2008). Sheshinski (2008) suggests that individuals may have more pessimistic beliefs about survival probabilities than is warranted by the evidence, thus reducing the attraction of annuities, although the evidence on this point is mixed. Other papers provide evidence that people often act as if they are placing too little weight on future versus current consumption (e.g., Warner and Pleeter 2001; Laibson 1997), a phenomenon that may reduce demand for annuities in some contexts. Hu and Scott (2007) suggest that individuals may use inappropriate decision rules due to a phenomenon known as "loss aversion."[6] Taken together, this growing body of research suggests that individuals are not making fully rational decisions when it comes to distributions from retirement plans.

Given low levels of financial literacy and the evidence that individuals are subject to behavioral biases, it is perhaps not surprising that a growing body of research has also shown that "employers matter." In other words, the decisions that plan sponsors make in designing retirement plans and communicating about them have important effects on the behavior of plan participants. In many cases, plan sponsor decisions can improve participant retirement security, such as when employers automatically enroll employees into a 401(k) plan and participation rates rise rather dramatically as a result (e.g., Madrian and Shea, 2001). In other cases, plan sponsor decisions can lead participants to engage in behavior that would not be advised by most economists or financial planners, such as when participants direct more of their own contributions to own-company stock when the employer restricts the company match to be held in own-company stock (Brown, Liang and Weisbenner, 2007). By not offering annuities, employers are implicitly signaling to participants that guaranteed lifelong income is not important.

2.2 Why Don't Employers Offer Annuities?

Research has established that (i) annuities are an important component of retirement security, (ii) employers and retirement plan design can have an important influence on the choices that participants make, and (iii) employers do not offer annuities. An important question is, therefore, "why don't employers offer annuities?"

The simple answer to this question is that employers have not had a sufficient incentive to do so. In a dynamic, competitive, market-based system, most firms will rationally provide employee benefits only when there is a clear business case for doing so. Often, benefit plans are used strategically to help recruit and retain employees, as well as to manage the workforce through means such as influencing a workers' health and productivity or a worker's retirement date. Of course, one major reason that these benefits are used instead of cash compensation is due to the favorable tax treatment that Congress has provided. The benefits to plan sponsors of offering any given benefit, however, must be weighed against the costs of administering a plan, as well as the costs and risks associated with meeting the many regulatory and fiduciary requirements imposed on plan sponsors.

To the extent that Congress has dealt with annuities in the past, the net result has often been to provide incentives for plan sponsors to *not* provide annuities. The most glaring example of this is the fact that for most of the history of 401(k) plans, plan sponsors were subject to a potentially significant fiduciary risk when choosing an annuity provider, and often responded by simply excluding annuities from the plan. As Perun (2004, p.11) states:

> "Legal advisers know the real reason why plan sponsors don't offer annuities. It is because they strongly advise their clients against them. In their view, annuities expose plan sponsors to a significant and long-term risk of fiduciary liability. And plan sponsors, more often than not, heed their advice."

This created a perverse situation in which plan sponsors who provided employees with a valuable option to reduce retirement income risk were effectively penalized by having to take on more fiduciary risk, while plan sponsors who left employees to fend for themselves faced no such risk. Fortunately, the Department of Labor clarified in October 2008 that the "safest annuity available" provision that prompted these concerns applied only to defined benefit plans.[7] However, three full decades of a strong legal bias against the inclusion of annuities has taken its toll. Essentially, the entire 401(k) industry grew and matured in a regulatory environment that discouraged the provision of annuities.

Interestingly, Congress has been willing to impose *minimum* distribution requirements on individuals, while showing virtually no interest in the opposite problem, namely, that individuals might exhaust their resources too quickly. While one way of meeting the minimum distribution requirements is to purchase an annuity, the other options give no meaningful consideration to the significant longevity risk that retirees face.

It is often argued that, in addition to operating in a regulatory environment that has not been particularly supportive of annuities, many employers see little tangible benefit to offering annuities to their retirees. It is sometimes suggested that, to the extent that benefit plans are used primarily to recruit, motivate and retain current workers, employers have the incentive to allocate their scarce H.R. resources toward benefits for which the "value proposition" can be easily explained to current employees. Annuities may be quite valuable to retirees, but the benefits of annuitization are much harder to make salient to younger workers. Of course, if all workers were so foresighted and rational that they fully valued any future annuities, then this could provide plan sponsors with the incentive to add these options as a recruiting or retention tool. But given low levels of financial literacy (e.g., Lusardi and Mitchell 2007b), the tendency toward myopia (e.g., Laibson 1997), and the fact that the employers tend to focus on wealth accumulation rather than annuitization (Brown et al 2008), it may not be realistic to expect that employee demand is sufficient to drive most employers to add annuity options.

Recent industry surveys, however, suggests that many employees *are* interested in having guaranteed retirement income, particularly in the aftermath of the recent turmoil in financial markets. For example, a recent report by MetLife (2009) indicates that "50 percent of all employees surveyed expressed an interest in having their company provide ways to convert retirement plan lump sums into income for life." Another survey of approximately 1,000 401(k) plan participants in March, 2009 – after six months of economic and financial market upheaval - indicates that "90 percent of all participants said they would be interested in seeing a retirement income option added to their plan" (Barclays Global Investors, 2009).

One would hope that the combination of the reduction in fiduciary risk brought about by the October 2008 Department of Labor rule and the increased interest of participants in having income options in their plan would lead employers to start offering annuities as part of their DC plans. It is too early to know whether this will occur on its own, but thus far, the number of plans that have moved to adopt annuity options remains limited. Indeed, the same MetLife report that found high participant interest in income options showed that a minority of plan sponsors viewed the addition of income options as an important part of their benefits strategy. Further action by the Department of Labor to address concerns about fiduciary risk, including those discussed in section 5 below, would be helpful.

2.3 A Role for Public Policy

As noted above, there are compelling reasons to believe it is in the public interest for individuals to have the opportunity to partially annuitize their 401(k) plan balances in order to provide a guaranteed source of retirement income. Providing this option through the employer-provided plan seems particularly important given the evidence that employers matter for influencing employee decisions.

By their actions, it appears that most employers do not yet have adequate incentives to provide annuity options. As a result, 401(k) plan participants are not presented with an annuity option at retirement, and instead are often presented with an implicit default option to take their retirement distributions in a lump-sum or a series of phased withdrawals. Because employees are not even faced with a choice set that includes annuities, many participants will not be stimulated to learn about the relative costs and benefits of annuitization versus alternative distribution options. This, in turn, depresses the demand for annuities and thus further reduces the employer's incentive to provide an annuity option in the first place. In essence, we have created a "self-fulfilling prophecy": employers don't offer annuities because employees don't demand them, and employees don't demand them because employers don't offer them.

Policymakers may be able to interrupt this negative cycle by encouraging plans to provide access to annuities. By encouraging the use of automatic annuitization program as the default distribution option, policy may also help to shift the dominant paradigm among plan sponsors and plan participants from one that is focused solely on wealth accumulation to one that is focused more broadly on retirement income security. But, is there any evidence that such a policy change would be effective?

3. WOULD AN "AUTOMATIC ANNUITIZATION" DEFAULT OPTION WORK?

As noted above, default options have been shown to influence a wide range of behaviors related to financial preparedness for retirement. In the context of 401(k) plans, there is evidence that defaults can influence whether to participate in a savings plan at all, how much to contribute, how to allocate one's portfolio, and more.

Beshears et al (2008) discuss a number of possible reasons that default options may have such a strong effect on behavior. These reasons include that it may be too complex to analyze and evaluate the alternative options, that individuals may be myopic and never get around to switching the election, and/or that individuals may view the default as providing an implicit endorsement from the plan sponsor in favor of the option selected as the default.

Given the preponderance of evidence that default options exert a strong influence on behavior in nearly every other aspect of retirement planning, it is quite likely that the use of automatic annuitization as a default option would alter distribution behavior as well. After all, it would be quite unexpected if individuals who were strongly influenced by plan design choices throughout their career suddenly became immune to plan design considerations upon retirement.

While this argument has intuitive appeal, there is very little empirical evidence available with which to estimate the magnitude of the likely effect. Nonetheless, the evidence that is available is largely suggestive of a default effect in the distribution phase.

One piece of evidence comes from the U.S. experience with survivor benefits. The Employee Retirement Income Security Act (ERISA) of 1974 required that the default annuity option from DB plans be a joint-and-one-half survivor annuity, unless the individual opted out of this by choosing a single life annuity with higher monthly benefits. In 1984, the regulations were amended to require an annuitant to obtain a notarized signature of his or her spouse in order to opt-out of the joint-and-survivor annuity requirement. Holden and Nicholson (1998) show that before 1974, less than half of married men chose a joint-and-survivor annuity. Following the passage of ERISA in 1974, use of the joint-and-survivor annuity rose by roughly 25 percentage points. Aura (2001) reports that the adoption of the spousal consent regulations in 1984 further increased the use of joint and survivor options by up to ten percentage points. This clearly supports the notion that the choice of the default matters.

Some recent evidence from Switzerland also suggests that defaults matter in the distribution phase. Bütler and Teppa (2007) examine the annuitization decisions of over 4,500 individuals in ten company pension plans. One of the ten companies uses a lump-sum default, and in this company the annuitization rate is only 10 percent. In contrast, an annuity is the default option in the other nine companies, and annuitization rates in these companies are much higher. Indeed, in 8 of the 9 annuity default plans, annuitization rates exceed 50 percent.

4. OBJECTIVES OF AN AUTO-ANNUITIZATION DEFAULT

There are many possible ways to design an automatic annuitization default option for DC plans in the U.S. This paper suggests that a well-designed annuitization program would:

1. **Make Annuities Available to All DC Plan Participants:** For reasons outlined earlier, efforts to promote annuitization will likely be ineffective if individuals who desire to purchase an annuity find it difficult or costly to do so. The most effective way to do this is to provide them with the option in their DC plans.
2. **"Change the Conversation":** Beyond simply making annuities available, an effective annuitization policy will help to re-frame the discussion of financial preparedness for retirement away from a narrow focus on wealth accumulation and toward a conversation about retirement income security. In addition to providing annuity options, the conversation between employers and employees can also be influenced by encouraging plan sponsors to provide an illustration of the retirement *income* (and not just wealth) consequences of saving, portfolio and distribution decisions as part of annual account statements during the accumulation phase.
3. **Preserve Individual Choice:** While there is a very rich academic literature examining the benefits of annuities to retirees, this literature also recognizes that annuities are not the optimal choice for every individual. An attractive feature of "opt out" default options is that they preserve the individual's right to choose an alternative option when it is in his or her interest to do so.
4. **Keep it Simple, While Encouraging Innovation:** There has been tremendous innovation in the retirement income product space in recent years, including the introduction of a wide range of retirement income products that combine the income guarantee feature of annuities with a number of other options (e.g., upside participation in equity markets, death benefits, etc.) This innovation is good for consumers, and as such, plan sponsors should have the right to include any/all of these options as distribution options in a 401(k) plan. However, in order to provide participants with a simple, transparent and easy-to-understand option, the standard default option should be kept relatively simple and focused primarily on providing the most cost-effective way to convert wealth to income.
5. **Avoid Irreversible Participant Mistakes:** There are many reasons that participants may respond so strongly to default options. In some cases, such as the fact that a default may be accompanied by information that justifies the choice of the default, defaults may be viewed as providing a form of financial education. In other cases, however, the response to a default may reflect financial illiteracy, myopia, or simply a lack of attention. Unlike the 401(k) plan participation decision, in which the consequence of "incorrectly" accepting the default is temporary (e.g., the consumer can stop participating and can withdraw the prior contributions after paying a tax penalty), the consequence of incorrectly accepting an annuity default could be permanent if the annuity contract were not reversible. In order to address this, plan sponsors should provide options for gradual annuitization, allow partial reversibility, or both.
6. **Minimize Burden for Plan Sponsors:** In general, U.S. employers are under no legal obligation to provide employees with a retirement plan. Thus, it is very important that policymakers balance the social benefits of encouraging annuitization against the potential costs that plan sponsors bear when adding elements to their plans. Retirement income security would be ill-served if attempts to improve the functioning of 401(k) plans led plan sponsors to conclude that they would be better served to drop the 401(k) plan and simply compensate employees through other means. Ideally, plan sponsors can be encouraged to voluntarily provide an annuitization default option, but to do so, the administrative, regulatory and financial burden on plan sponsors must be kept low. Ultimately, if automatic annuitization programs prove successful at increasing retirement security among participants, but voluntary adoption of automatic annuitization by plan sponsors remains limited, Congress could consider taking further steps toward making automatic annuitization a requirement for plan qualification.

5. A PROPOSAL FOR AUTOMATIC ANNUITIZATION

5.1 Steps to Encourage Automatic Annuitization

Under this proposal, policymakers would take specific steps to encourage DC plan sponsors to adopt an automatic annuitization plan as the default option for plan participants. This encouragement would come in three forms:

1. **Default Annuity Fiduciary Relief:** Plan sponsors who adopt automatic annuitization plans as outlined below would receive fiduciary relief similar to that offered under the qualified default investment alternatives rule in the accumulation phase. That is, with sufficient advance notice and the effective opportunity to elect otherwise, the participant - and not the plan's fiduciary – would be deemed to have elected the annuity.
2. **Illustrate DC Benefits as Annuity Payments:** Research has found that consumers find annuities more attractive when they are presented in a "frame" that emphasizes income and consumption, rather than wealth and investment. In order to emphasize the benefits of annuitization and perhaps stimulate demand for annuities by plan participants, the content requirements under the ERISA quarterly benefit statements rule should be expanded to include an illustration of how a participant's account balance converts into guaranteed monthly income for life.[8]
3. **Provide QJSA Administration Relief:** The QJSA rules add administrative complexity and attendant liabilities that employers can most easily avoid by excluding annuities from their plans. There are at least two specific changes to these rules that may help encourage plan sponsors to offer annuities. First, ERISA should be modified to allow, upon mutual agreement, plan sponsors to shift the responsibility for QJSA administration and liabilities to an annuity administrator. Insurance companies have more experience and expertise than plan sponsors in managing annuity administration and risk, suggesting that this policy would allow for a more efficient allocation of risk. Second, ERISA should be modified to permit the greater use of electronic means for administration of the QJSA rules. Electronic administration is commonplace in all aspects of modern life including the management of individual financial affairs (e.g., banking and tax filing), and it would be appropriate to allow this technology to be used here.[9]

5.2 Criteria for to Qualify as a "Qualified Automatic Annuitization Program"

In order to qualify as a Qualified Automatic Annuitization Program, plan sponsors would need to choose an annuity arrangement that meets the following criteria:

1. The default option would be triggered upon the request by an employee for a withdrawal from the plan (except that hardship withdrawals would be excluded.) In practice, this would apply to any distribution request after the age of 55 for workers that have separated from service or age 59 ½ for current employees. For individuals who have not requested a distribution by the point at which required minimum distribution (RMD) rules apply, the automatic annuitization default would take effect at age 70 ½. (As discussed below, the RMD rules may need modified to ensure that an annuity default is considered sufficient for meeting the RMD requirements.)
2. At the time the distribution request is made, the total DC account balance would be divided into two equal pieces, hereafter called the "cash account" and the "annuity account." The funds in the cash account (equal to half of the total 401(k) account balance at the time the initial distribution request is made) would be available for lump-sum withdrawal, periodic withdrawals or could remain invested according to the plan rules governing participant investment choices. The "annuity account" (equal to one half of the total account balance) would be automatically annuitized, unless the participant actively chooses to opt-out.
3. The "annuity account" balance would be used to purchase an immediate life annuity contract with the first payment commencing within 60 days of the distribution request. Alternatively, the plan sponsor could elect to automatically annuitize no less than 20 percent of the "annuity account" within 60 days of the distribution request, provided that annuity contracts of equal or greater size are purchased no later than each yearly anniversary of the initial distribution request, until such time as the full "annuity account" is annuitized.
4. In any case, if more than 25 percent of the "annuity account" (i.e., more than one eighth of the overall 401(k) balance) is annuitized in any 6-month period, then the annuity contract would be subject to a "trial period" of at least three months, and no more than 24 months. During this time, an annuitant may cancel the annuity contract and receive a refund of the annuity premium minus the present value of the payments already received.
5. The default annuity must be a joint-and-full-survivor annuity for married couples or a single-life annuity for

unmarried individuals. The annuity will not include other features, such as refunds, period certain or guarantee provisions.

6. The annuity payouts must either be escalating at a pre-determined rate of 2 to 5 percent annually or indexed for inflation.
7. The participant must be able to opt-out of the annuity contract. In the case of a married participant, the spouse must provide consent to change the distribution method. Individuals who opt out may choose from the other distribution options that the plan sponsor chooses to provide, including, but not limited to, a lump-sum distribution, a phased withdrawal program, or other income options.
8. Plan sponsors would be permitted to impose a minimum "annuity account" size of no greater than $20,000.
9. Credit for in-plan annuities: For plans that enter participants into deferred annuity contracts during the accumulation phase, the actuarial value of the life-contingent portion of these contracts would count toward the minimum annuitization requirement.

6. QUESTIONS AND ANSWERS ABOUT THE PROPOSAL

6.1 Why Is Policy Intervention Needed to Encourage Automatic Annuitization?

The ability to convert wealth to income by purchasing annuities is important for ensuring retirement income security. Yet a large majority of 401(k) plan sponsors have chosen not to provide participants with the option. As noted at length above, many plan sponsors view the regulatory and fiduciary burdens of offering annuities as outweighing the benefits of providing them. This proposal suggests that policymakers take proactive steps to reduce the fiduciary and administrative burden on providers by providing fiduciary relief to plan sponsors who provide annuity options that meet certain conditions and by simplifying the administration of QJSA rules. The goal of these actions would be to remove some of the barriers to voluntary provision of annuitization options that currently exist.

6.2 Why Not Make Automatic Annuitization Part of Plan Qualification Requirements?

Historically, policymakers have provided favorable tax treatment to private sector retirement plans in order to promote retirement security. In return, policymakers have sought to ensure that various policy objectives are met by imposing various requirements on plans, ranging from funding rules to non-discrimination rules to eligibility requirements to minimum distribution requirements. For many decades, these tax benefits accrued primarily to DB plans that provided annuity income as a matter of course. Arguably, the absence of a focus on annuitization from 401(k) plans is more of an unintended consequence of the shift from DB to DC, rather than a primary reason or justification for this shift. By including automatic annuitization as part of plan qualification requirements, policymakers would help ensure that 401(k) plans offer the "best of both worlds." DC plans with an automatic income option would provide participants with the same option for guaranteed lifelong income that DB plans used to provide, while preserving individual choice for participants and preserving the employer advantages of DC plans, such as more predictable funding needs. In an important sense, by addressing the major flaw in the existing design of 401(k) plans, requiring annuities as a default option may actually increase the long-run viability of the 401(k) plan as a central component of the nation's retirement income landscape.

Given the "revealed preference" of employers not to offer annuities in a purely voluntary system, it may be that a plan qualification requirement would be the most effective and efficient way to promote annuitization within 401(k) plans while still preserving the participant's right to take alternative distribution options. However, despite the many theoretical advantages of including automatic annuitization as part of plan qualification requirements, there is – so far – too little empirical evidence and experience to be fully confident in the effect of these provisions on plan sponsor and participant behavior and well-being. Available evidence from the U.S. and abroad is certainly suggestive of an effect, but the evidence is not sufficiently rich or robust to be fully confident in the effect of an automatic annuitization policy in the U.S. DC plan environment. By providing fiduciary relief to plan sponsors who offer such plans, we would not only encourage voluntary provision, but we would also gain valuable data and knowledge that could guide subsequent policy development in this area.

6.3 Doesn't Social Security Already Annuitize Enough?

Social Security provides a valuable annuity to most seniors in the U.S., and this annuity has the added benefit of being annually indexed to the rate of inflation. Social Security replaces, on average, only 42 percent of pre-retirement income.[10] Replacement rates are, on average, substantially higher for lower income households, and researchers (e.g., Scholz, Seshadri and Khitatrakun, 2006) have calculated that Social Security may currently be generous enough to allow the lowest income households to maintain their pre-retirement level of consumption through retirement. However, for the majority of the U.S. population, Social Security is not sufficient to maintain pre-retirement living standards. Social Security replacement rates are expected to fall in the future (Munnell 2003), and given the substantial long-term fiscal problems facing the Social Security system, replacement rates may fall further in the future. Thus, for most of the U.S. population, Social Security is not a sufficient source of guaranteed retirement income. DC plan participants seem to understand this: according to a March 2009 survey of 401(k) plan participants, "only 13 percent feel that Social Security will provide sufficient guaranteed monthly income in retirement" (Barclays Global Investors, 2009).

The limited role of Social Security, the decline of DB pension plans, and the limited size of the retail annuity market make it clear that employer-sponsored DC plans are the natural place – indeed, perhaps the only place – where policymakers have the opportunity to ensure worker access to guaranteed lifelong income.

6.4 Why Would the Default Apply to Only Half of the Account?

Retirees face a number of important financial risks in retirement. Some of these risks – such as longevity risk, or the risk of outliving one's resources – are clearly best addressed through having a steady source of guaranteed income that cannot be outlived. Other types of risk – such as that of an unexpected need for liquid wealth to cover an uninsured medical expenditure – are better addressed by having a buffer stock of non-annuitized, financial wealth. Given this, it is likely in the interest of most retirees to annuitized part of their 401(k) balance, but not all of it.

If the default level of annuitization is set too low, then the individual "steps" in the annuity ladder will be so small that the administrative costs associated with the annuity contract may be too large relative to size of the annuity payouts. If the default is set at too high a level, individuals who want to preserve some of their wealth in a non-annuitized form may opt-out of the default entirely. Thus, an excessively high default annuitization rate may inadvertently lead to lower levels of annuitization.

Beyond these very general guidelines, economic models show that it is difficult to provide simple "rules of thumb" for an annuitization level that would be appropriate for all or even a majority of households. Models can lead to different assessments of the "optimal" level of annuitization due to the heterogeneity in household financial situations and preferences. The absence of simple rule-of-thumb does not, of course, justify the current policy in which zero annuitization is the usual default. It does, however, underscore the importance of allowing individuals the ability to opt-out or modify the annuitization plan according to their needs.

As a starting point for thinking about an appropriate level of annuitization, I have previously suggested that a retiree or near-retiree calculated their expected "monthly income gap" as the difference between their "essential expenditures" and their "guaranteed monthly income."[11] Essential expenditures includes any expenditure that an individual feels is necessary to maintain a comfortable living standard. For some people, this may include only the "basics," such as shelter, food, transportation and health care. Others may wish to include travel, assistance to family members, hobbies, or any other expenditure that they believe is essential to maintaining a desired living standard. Guaranteed monthly income includes Social Security, income from a defined benefit pension plan (if any), and any other sources of guaranteed lifetime income. The least expensive way to fill this income gap is to purchase a life annuity to provide a steady stream of income that is sufficient to cover one's essential expenses for life.[12]

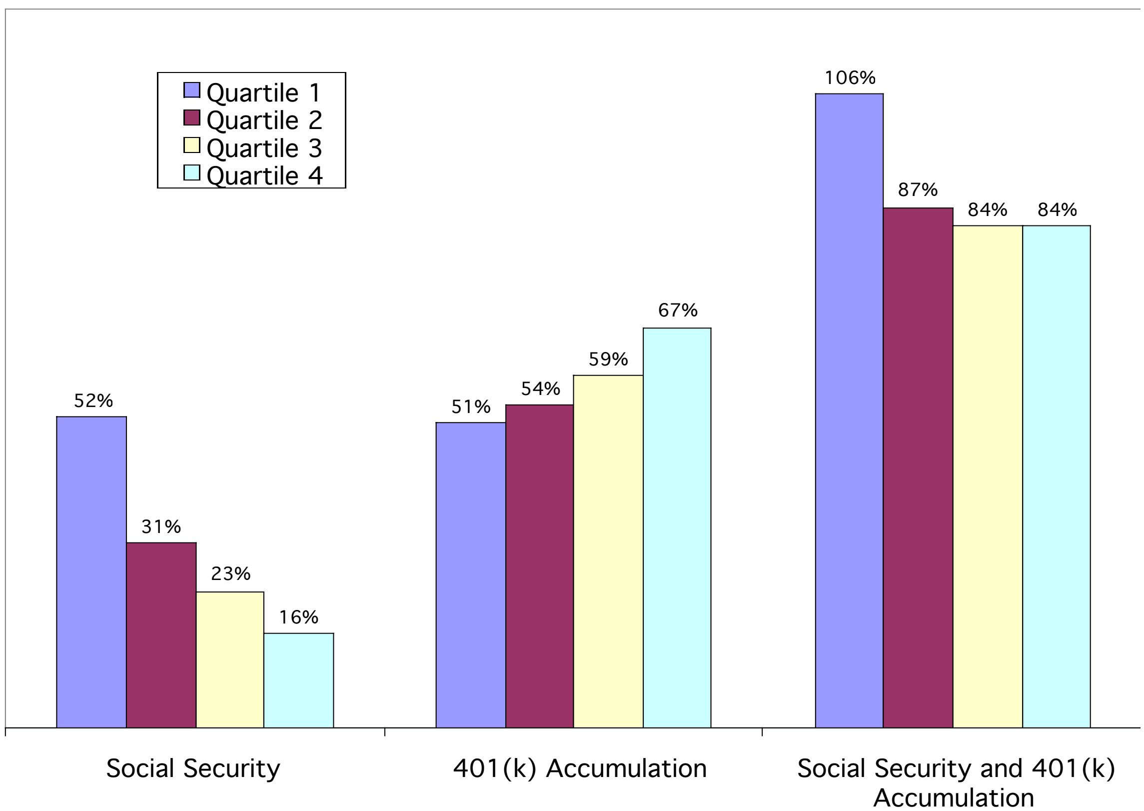
Because different households will define their essential expenditures differently, the actual distribution of this income gap across the population is not known. However, we do know that Social Security replaces less than half of pre-retirement income for most households: as noted above, the "replacement rate" for medium earners is approximately 42 percent. For individuals without other sources of guaranteed income, this leaves a gap, even after allowing for opportunities to optimally reduce consumption after retirement (e.g., eliminating work-related expenses, substituting home production for market-purchased consumption, etc).[13]

Data from EBRI/ICI 401(k) Accumulation Projection Model provides further perspective, although for present purposes, this analysis is subject to several important caveats.[14] Figure 1 reports the median replacement rates for participants turning 65 between 2030 and 2039 by income quartile at age 65. As previously noted, Social Security replacement rates exceed 50 percent for those at the bottom of the income distribution, but these replacement rates drop substantially for those in higher income quartiles. In contrast, the replacement rates achievable by annuitizing 401(k) accumulations rise with income.

According to the data in this figure, the vast majority of individuals would likely not have sufficient annuitized income if they relied solely on Social Security. At the other extreme, were individuals to annuitize their entire 401(k) balances (including IRA rollovers), the replacement rates would exceed those recommended by most financial planners. This, combined with the fact that most realistic models and financial plans would suggest that an optimal retirement security "portfolio" would include both annuitized and non-annuitized wealth, suggests that partial annuitization of DC account balances is appropriate.

FIGURE 1

Median Replacement Rates for Participants Turning Age 65 between 2030 and 2039,
by Income Quartile at Age 65 (as percentage of final five-year average salary)



Source: Holden and VanDerhei, 2005, EBRI Issue Brief No. 283, p. 9, Figure 3.

6.5 Why a Joint and Full Survivor Annuity?

It is generally accepted that the resources needed to maintain a given standard of living depend on whether or not an individual is part of a larger household that shares some resources. In economics, there is a large literature on household "equivalence scales" that seeks to estimate the extent to which there may be economies of scale with household consumption. A recent paper by Browning, Chiaporri and Lewbel (2006) finds that "couples save the equivalent of about one third of their total expenditures through shared and joint consumption of goods … and that singles need to spend between one half to three fourths as much as couples to attain the same standard of living by themselves as they attain as members of a two person household."

Given this, it would seem natural to set a "survivor benefit" that is in this range. However, there is a substantial body of research indicating that the death of a spouse is often accompanied by a substantial decline in living standards, especially for women. One reason for this is that a newly widowed individual will typically find her household Social Security income drops by one-third to one-half.[15] Of course, foresighted couples could easily rectify these consumption drops by purchasing life insurance, but several studies have documented the widespread under-utilization of life insurance (e.g., Bernheim et al 2003a, 2003b).

Given the financial risks to which many spouses are exposed, it seems desirable to err on the side of defaulting couples into a higher, rather than a lower, survivor benefit ratio. It is also worth noting that, because only half of the account would be subject to the annuity default, a 100% survivor ratio on half of the account is roughly akin to a 50% survivor ratio on the entire DC plan account balance. As a result, this would make the survivor benefit from DC plans roughly akin to that required under the QJSA rules for DB plans. Ideally, of course, plan sponsors would provide participants with the option to alter the survivor ratio, subject to the consent of the spouse.

6.6 Why an Escalating or Indexed Annuity?

Over the past 80 years, inflation in the U.S. has averaged just over 3 percent per year. At a steady rate of 3 percent per year, the real purchasing power of a fixed, nominal income stream is halved in just under 24 years.

In theory, the preferred approach to handling inflation risk is to provide inflation-indexed annuities. Several companies provide life annuities that are explicitly or implicitly linked to changes in the consumer price index. However, for a variety of reasons, the inflation-indexed annuity market in the U.S. is less developed than the nominal annuity market, suggesting that it may be premature to require that the default annuity be inflation-indexed. Nonetheless, any plan sponsor that wishes to provide an inflation-indexed annuity should clearly be permitted to do so.

Unless and until the inflation-indexed annuity market matures, an alternative option for at least partially addressing the inflation issue is to provide an escalating annuity, that is, an annuity with payouts that grow over time at a predetermined rate of 2 – 5 percent. It should be acknowledged that an escalating annuity does not fully protect individuals against the risk of inflation, for two reasons. First, the average level of inflation may deviate from any pre-determined escalation rate. If inflation turns out to be higher than the chosen escalation rate, the real purchasing power of the annuity will still fall over time (although by much less than if the annuity did not have any escalation feature). Conversely, if the average inflation rate turns out to be lower than 3 percent, the purchasing power of the annuity would actually grow over time. Second, even if the average level of inflation is correct, annual variations in the rate of inflation will lead to annual variations in the purchase power of any fixed income stream.

Nonetheless, an escalating annuity does provide some protection against the loss in purchasing power. Restricting the rate of escalation to a narrow range (such as 2 – 5%) is also desirable to prevent individuals from excessively front-loading or back-loading the annuity payout stream. Limiting the range of escalation is also important in order to limit concerns about adverse selection over product type. [16]

6.7 Is the Opt-Out Requirement Unduly Burdensome?

Central to the argument in favor of using default options rather than requiring annuitization is an understanding that individuals – even financially unsophisticated ones – are generally in a better position to understand their own financial circumstances than is the government. The option to “opt-out” of a default is very important to preserving individual choice in this context.

This argument only has meaning, however, if individuals who wish to opt out are able to do so without incurring unduly burdensome costs. Many have suggested that the fact that the waiver of the QJSA option in DB plans can not be done electronically places an unnecessary administrative burden on plan sponsors (e.g., Wray, 2005). Given that the technology now exists for married spouses to electronically sign tax returns, there seems to be no reason that similar technology could not be used in this case.

While the evidence on the ease of opting out is limited, there is at least some evidence suggesting that individuals who wish to opt-out of an annuity are able to do so. Specifically, a recent study by Mottola and Utkus (2007) examines the lump-sum versus annuity decision of participants in two large U.S. defined benefit plans. They find that only 25 percent of married individuals choose the annuity, despite the fact that individuals must have their spouse waive the right to a joint-and-survivor annuity via a notarized, written document.

This finding is, of course, a double-edged sword. On the one hand, it suggests that when the annuity is the default, a majority of married couples still take the lump-sum. On the other hand, a 25 percent annuitization rate is far higher than we observe in 401(k) plans, suggesting that the default does raise annuitization rates. Further, it gives comfort that those individuals who choose not to accept the default are able to opt-out at relatively low cost.

6.8 How Should Small Accounts Be Treated?

Individuals who reach retirement age with relatively small account balances present a special challenge. To the extent that the small account balance still represents a significant share of the individual’s net worth, it is certainly possible to argue that it is even more important for this person to annuitize in order to maximize the income from this limited savings. On the other hand, it makes little practical sense to convert a very small lump-sum into very small monthly income checks. It is not uncommon, for example, for providers of single premium immediate annuities to require a minimum initial premium, presumably to ensure that the administrative costs associated with servicing the annuity contract remain small relative to the size of the monthly check.

Given the basic structure of this default – namely, that only 50 percent of the account would be annuitized, and that under some options the annuitization could be spread across five distinct contracts under the laddering program – this suggests that employer should have the option of excluding accounts under $40,000 from this default distribution option. Given the 50 percent annuitization default, this would translate into a minimum annuity account size of $20,000, which, anecdotally, is large enough such that the fixed costs of providing an annuity are not overly large relative to the account size.

6.9 How Should In-Plan Annuity Options be Treated?

In recent years, a number of financial services providers have created innovative income-oriented products that are designed to be integrated into 401(k) plans during the accumulation phase. For example, some products allow individuals to essentially purchase deferred annuity units during the accumulation phase. Given that these products clearly serve the policy objective of providing guaranteed retirement income options, their role should be recognized as such.

In general, when a 401(k) plan includes an embedded annuity feature as part of the plan design, the actuarial value of that future annuity stream should be treated as though it is part of the "annuity account." For example, if a participant on the date of their first distribution request has $100,000 invested in non-annuitized securities and $50,000 (in actuarial net present value) in annuity contracts, the total value of the DC account for purposes of this rule would be $150,000. In order to meet the "equal division" requirement between the cash account and the annuity account, the $50,000 in annuity value would count towards the annuity account balance. Thus, in this example, another $25,000 of the $100,000 in non-annuitized plan assets would need to be placed in the automatic annuitization plan.

When calculating the actuarial value of annuity contracts for purposes of meeting the 50 percent annuitization rule, only the life-contingent portion of the benefits should be included. Thus, for example, if a plan sponsor offers a deferred annuity contract during the accumulation phase that carries a refund option upon death, a period-certain option, or other similar option that provides payments after the death of the annuitant(s), the actuarial value of these options *would* be counted when valuing the total account balance at the time of the distribution request, but *would not* be counted as part of the annuity account. Put differently, the actuarial value of these non-life-contingent options would count as part of the "cash account" rather than the "annuity account."

6.10 What About Other Income Products?

Among the many innovations in the market for retirement income are products that offer individuals a guaranteed minimum withdrawal benefits (GMWB), guaranteed minimum income benefits (GMIB), and other approaches to retirement income. These products often offer individuals with "upside potential" to a diversified portfolio, while limiting the downside risk through guaranteeing a series of minimum withdrawals. Plan sponsors should certainly be permitted to include these products in the menu of withdrawal options.

In general, however, this proposal suggests that such approaches only serve as the default option if there is a true life-contingent annuity component to the product, that is, a minimum level of income that is guaranteed to last for life. In such cases, the "annuity account" would be credited with the present value of the portion of these benefits that is guaranteed for life. Thus, for example, if a product offers "upside exposure" to equity returns, but guarantees a minimum payout of no less than $500 per month for life, then the annuity account would be credited as if a $500 per month life annuity were purchased.

6.11 When should the Default Begin?

The financial circumstances and retirement plans will vary widely across individuals who participate in 401(k) plans. Given this, it is difficult to establish a pre-determined age at which the default payout option should begin. If the age was set too young, then it might serve to promote earlier retirement and an earlier "tapping" of retirement resources. Given the individual and macroeconomic advantages of extending working lives, policymakers should avoid policies that might inadvertently signal an endorsement of an earlier exit from the labor force.[17] At the same time, a default distribution option will have no meaningful impact if it is not triggered until an age beyond that at which most people are making their initial distribution decision.

The most sensible way to balance these factors is to have the default distribution option triggered upon the participant's first request for a distribution, other than a hardship withdrawal or loan, provided that this request does not trigger an early-distribution tax penalty. Effectively, this means that the default option would be triggered for distribution requests that occur after age 59 ½ or after separation from service if the separation occurred during or after the calendar year in which the employee reaches age 55.

Regarding the exceptions, it should be noted that loans are generally limited to 50% of a participant's vested accrued benefit and may be satisfied from the participant's "cash account." As for hardship withdrawals, the plan sponsor is required to make sure that the hardship criteria are met before a hardship request is honored. It would seem wrong to impose a default payment form other than a lump sum to satisfy an immediate and heavy financial need.

The default would also need to be integrated with the required minimum distribution (RMD) rules. Under these rules, distributions generally must begin by April 1 of the year following the calendar year in which a participant reaches age 70.5 (although this can be delayed for most individuals who are still employed at age 70.5). Under the existing RMD rules, participants must take payments no slower than at least one of the available RMD options.

While beyond the scope of this paper, the RMD rules themselves would ideally be revisited by Congress. The current rules do not provide adequate recognition of the important role that annuities play in providing retirement income security, and could serve as a hindrance to some innovative retirement income solutions. The fact that the triggering age for the RMDs has not been increased in many years despite advances in life expectancy also suggests that these rules ought to be revisited.

Assuming the RMD rules are not changed, then in order to be in compliance, some methods of implementing the automatic annuitization default may need to be modified. For example, if an employer wishes to use a laddered annuity program spread over four years, then this program may need to be started four years in advance of the RMD trigger to ensure compliance. As a middle ground, Congress could simply modify the RMD regulations to clarify that distributions that meet one of the automatic annuitization default options would automatically qualify as meeting RMD standards.

6.12 Why does this Default Apply Only to Employer Sponsored Plans and not IRAs?

DC plan balances are often rolled over into IRAs when a participant separates from a job. As a result, aggregate balances in IRAs are substantial: according the Federal Reserve's Flow of Funds data, IRAs held $4.7 trillion in assets in 2007 compared to $3.7 trillion in DC plans.[18] In principle, the rationale for converting DC account balances into annuities clearly extends to IRAs, especially given such large balances. It is also generally desirable to have consistent rules across various types of retirement vehicles in order to avoid the creation of incentives for individuals to alter their account type simply to gain access to more favorable rules.

This proposal begins with employer-sponsored plans, however, due to the important role that employers play in influencing participant behavior, both through plan design decisions and through employee communication. This suggests that employer-sponsored plans are the venue in which this policy is most likely to be effective. Thus, while ultimately extending this policy to IRAs is desirable on theoretical grounds, it seems prudent to first begin with employer-sponsored plans. Because the auto-annuitization program is only a default option, and not a requirement, this is one instance where there is no real reason to be concerned about individuals rolling over into an IRA simply to avoid the default. Put simply, it is quite likely that the effort required to opt out of the annuity default would be substantially less than the effort required to transfer one's account balance from an employer's DC plan into an IRA.

6.13 Why is there a Trial Period for Some, But Not All, Default Options?

Gale et al (2008) discuss a number of sensible rationales for why a trial period would be beneficial to participants. If an employer were to automatically and immediately annuitize a large fraction of the account into a non-reversible annuity contract, the potential for permanent mistakes is high. One can easily imagine a terminally ill individual who is distracted by health concerns being defaulted into an annuity contract that, given his health condition, is far from ideal. Under this proposal, such participants are protected in two possible ways. If the default annuity contract is one in which more than one-quarter of the annuity account (one eighth of the overall account) is immediately annuitized, then the individual would have a reasonable window of opportunity in which to "undo" the annuity. Alternatively, if the contract is one that purchases laddered annuities, then the individual is at risk only for individual "steps" in the annuity ladder, thus limiting the overall exposure. The proposal allows plan sponsors to do both, i.e., offer a default annuity that is laddered and in which each step in the ladder has a trial period. The rationale for having an upper limit of two years on the trial period is to avoid defaults that essentially "undo" all the annuitization.

6.14 How to Address Concerns about Counter-Party Risk?

The recent turmoil in financial markets has served as a stark reminder that even long-standing financial institutions can enter periods of financial distress. Babbel and Merrill (2006) discuss that even a small probability of default on the part of the insurance company can serve as a significant barrier to annuitization. As summarized by Gale et al (2008), "to have a robust annuity market, consumers must have faith that the benefits from their annuity contracts will be paid."

Currently, annuity contracts are "insured" by state guaranty funds, with coverage that varies across states. All states provide coverage for at least $100,000 of annuity value, some up to $500,000. If a plan sponsor is concerned that state variations offer inadequate or unequal protection to retirees, they could partially mitigate this risk by having multiple insurers involved in the provision of annuities.

Gale et al (2008) suggest that "a federal insurance agency patterned on the Federal Deposit Insurance Corporation (FDIC) could provide uniform insurance coverage and establish uniform financial standards and safeguards for consumers." While such a role for federal insurance is theoretically attractive, in practice federal insurance programs such as the FDIC or the Pension Benefit Guaranty Corporation (PBGC) have significant structural flaws that limit the extent of protection, create perverse incentives for the insured entities, and/or put substantial risk onto the taxpayer, often because of the government's unwillingness or inability to price the insurance appropriately.[19] Many private sector alternatives to a government insurance program exist, including effective use of risk management tools, the use of reinsurance markets, securitization of risks, and so forth. These tools could be required or encouraged through more effective regulation.

7. EXAMPLES OF QUALIFIED DEFAULT ANNUITY PLANS

The proposed rules governing an automatic annuitization default are meant to be sufficiently flexible so as to allow plan sponsors the ability to choose from a number of alternative approaches. Below are described three alternative approaches that could satisfy these minimum requirements. These examples are not meant to be collectively exhaustive of the numerous possible plan designs that could achieve the policy objectives of an annuity default, but rather are meant to illustrate the broad range of alternatives that could be considered.

7.1 Immediate Annuitization with a Trial Period

One approach, as proposed by Gale, Iwry, John and Walker (2008), is to allow a trial period. According to their proposal, individuals would be defaulted into a two-year "trial income product." Unless an individual affirmatively opts out, "Retirees would receive twenty-four consecutive monthly payments from the automatic trial income plan. At the end of the trial period, retirees may elect an alternative distribution option or, if they do nothing, be defaulted into a permanent income distribution plan. Employers and plan sponsors would be encouraged to offer the trial income plan and would have discretion over some of its structure and implementation."

Provided that this approach (the details of which can be found in their paper) met the other conditions (e.g., triggered upon initial distribution request, at least 50 percent of account balance included, annuity is escalating or inflation-indexed, etc), then this approach would satisfy the auto-annuitization program outlined above.

7.2 Laddered Annuitization

Laddered annuitization refers to the idea of spreading annuity purchases out over time, rather than purchasing a single immediate annuity contract. Under this approach, a plan sponsor could convert one-fifth (20 percent) of the annuity account at the time of the initial distribution request into an immediate annuity, with the first payout to occur no later than 60 days after the distribution request is made. Then, on each of the four subsequent anniversary date of the initial distribution, an additional annuity would be purchased with a premium equal to 1/n of the account balance, where n = 5 minus the number of annuity contracts already purchased.[20]

To make matters concrete, suppose that at the time of an initial distribution request, an individual has a $100,000 annuity account balance. Upon the initial distribution request, $20,000 (1/5 of $100,000) would be used to purchase an annuity. The remaining $80,000 would continue to be invested as directed by the participant in accordance with plan rules. If, over the subsequent year, the remaining annuity account balance earned an investment return of 5 percent ($4,000), then the second year annuity purchase would be equal to $21,000 (1/4 of $84,000). By following this schedule, the full annuity account will be annuitized in five approximately equal (differing only by investment returns) pieces.[21]

There are two advantages to this approach over annuitizing the entire annuity account at a single point in time. First, it helps to limit the risk of inappropriate annuitization. As noted earlier, annuitization will not optimal for 100 percent of the population, and there will, inevitably, be some individuals who accept the default option even when it is not in their interest to do so. Because an annuity default is more difficult to "reverse" than other types of default options, it is important that individuals not be put into a situation in which they have been defaulted into a sub-optimal, irreversible situation with all of their retirement wealth. With a laddered annuity approach, the initial annuity purchase only annuitizes 10 percent (20 percent of 50 percent) of the total 401(k) account balance. Should the individual realize that he or she made a mistake in accepting the default option, he or she would still have the ability to opt-out of subsequent steps in the annuity ladder and effectively be able to access 90 percent of the 401(k) account balance using any alternative distribution strategy.

Second, spreading the annuity purchases out over time provides some automatic averaging over fluctuations in asset values and interest rates. This strategy helps to minimize the risk of having an individual annuitize their entire account balance on a day in which, for example, their portfolio value has suffered a negative shock and/or interest rates (which are a primary determinant of annuity prices) are very low. Of course, it should be noted that a well-designed annuity payout option that is integrated with a well-designed portfolio strategy can limit this risk even without laddering. For example, if a life-cycle fund shifts towards a predominantly bond portfolio as one approaches retirement, and if the bond portfolio is of a similar duration as the annuity product that will ultimately be purchased, then there is already a built-in "hedge" against asset and interest rate risk. Were interest rates to decline, bond prices and annuity prices would increase in approximately equal amounts, meaning that the amount of monthly income that could be purchased by the individual would remain largely unchanged.

7.3 In-Plan Annuity Options

A number of financial services providers are currently offering plan sponsors the opportunity to include an annuity in the plan during the accumulation phase. Some products offer individuals an opportunity to purchase deferred annuity contracts in place of investing in a fixed income option. Other products direct employer 401(k) matching contributions into deferred payout annuities rather than into alternative investments. Still other products offer opportunities to phase-in to a series of minimum income or minimum withdrawal guarantees as one approaches retirement.

These approaches should be encouraged by policy. In addition to providing valuable distribution options that include guaranteed income, these products also have the added benefit of encouraging 401(k) participants to start thinking about income, rather than just wealth accumulation, earlier in one's career.

Thus, these products should "count" towards meeting the automatic annuitization rules. In recognition of the fact that some product providers, plan sponsors and participants may wish to include in-plan options that have additional features beyond guaranteed income (e.g., guarantees), it is important that they be accounted for in a manner that accurately captures the annuitization component of the product. Nearly any guaranteed lifetime income product can be mathematically decomposed into a combination of a simple life annuity and a package of other (sometimes complex) financial instruments. This proposal suggests that this decomposition should be done, and that the present value of the "annuity" portion of the product be credited towards meeting the 50 percent annuitization rule, whereas the non-annuity piece be included in the overall measure of the initial DC account balance. While this will require that policymakers adopt a set of standard assumptions for doing so (e.g., choice of life tables, interest rate assumptions, etc.), the details of these calculations can be worked out through the standard regulatory processes.

8. SUMMARY AND CONCLUSIONS

Policymakers rarely have the opportunity to design policy on a clean slate. Instead, policy must be designed to take into account a host of pre-existing policies, institutions, and precedents that narrow the range of options moving forward. This is certainly true in the U.S. retirement system, where many decades of legislation, regulation, plan evolution, and product innovation have created a complex set of existing rules and institutions. The existing retirement plan landscape in the U.S. has evolved over the decades in a number of ways that policymakers may not have fully anticipated or intended.

Without question, the most important change in U.S. retirement landscape over the last few decades has been the tectonic shift of employer-sponsored plans away from DB and toward DC. This shift has been accompanied by a large number of tangible benefits to both employers and employees. DC plans have continued to evolve, as has the public policy environment in which they operate. As recently as the Pension Protection Act of 2006, Congress demonstrated – such as through provisions to encourage automatic enrollment - its understanding that the regulation of 401(k) and other DC plans needs to keep up with developments in research and practice in order to improve the ability of our employer-sponsored retirement plan system to meet the many private and public objectives that this system is meant to serve. Plan sponsors and financial services providers have also demonstrated a continued commitment to product innovation with the introduction of a wide range of products designed to help participants participate, save, invest, and diversify.

Unfortunately, the evolution of DC plans into more effective retirement plans has largely been limited to issues related to wealth accumulation. While there has been a tremendous amount of product innovation in the retirement income product space in recent years, plan sponsors and policymakers have been slower to take the steps necessary to ensure that participants have effective retirement income tools at their disposal. With the continued decline of DB plans, the expected reduction in Social Security replacement rates that are already in current law, the potential for additional Social Security reductions to address issues of fiscal sustainability, and the limited individual market for annuity products, employer-sponsored DC plans emerge as the most effective place to ensure that retirees have adequate access to the guaranteed lifelong income.

Were DC plans to provide automatic annuitization as the default payout option, participants would be provided with the products, information and guidance they need to provide for a secure retirement. By converting DC plans from a tool focused almost exclusively on wealth accumulation to a tool that is more broadly effective at promoting overall retirement income security, an automatic annuitization option will ensure the long-run viability of the DC system as an effective and sensible approach to retirement policy in the U.S.

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ENDNOTES

1 For more discussion of how annuities provide a higher level of sustainable lifetime income, see Brown (2004)

2 In practice, a non-hardship withdrawal would include any distribution request after the age of 55 for workers that have separated from service or age 59 ½ for current employees.

3 This literature begins with the seminal paper of Yaari (1964) and now includes many dozens of papers. For a review of much of this literature, see Brown (2009).

4 This higher return is sometimes referred to as a "mortality premium" or as a "mortality credit" in the academic literature (e.g., Milevsky 2006). Readers interested in an analysis of the numerous hypotheses on the under-annuitization puzzle and the academic research that supports or refutes the various hypotheses can find a summary in Brown (2009).

5 For a discussion of the fact that individuals who self-select into the individual annuity market have lower mortality rates and greater life expectancies than the general population, and for evidence on the impact that this selection has on annuity prices in the U.S., see Mitchell, Poterba, Warshawsky and Brown (1999).

6 Readers interested in a more detailed review of the literature on both rational and behavioral explanations for why consumers do not annuitize more often will find such a review in Brown (2008a).

7 As summarized by J.P. Morgan (2008): "With respect to the safest available annuity requirement, the applicable rule (Interpretive Bulletin 95-1) was amended October 6, 2008, to provide that it only applies to defined benefit plans. With respect to DC annuity purchases that do not comply with the safe harbor, the Pension Protection Act (PPA) provides that they are "subject to all otherwise applicable fiduciary standards." The final safe harbor rule adds clarifying language that the new rule "does not establish minimum requirements or the exclusive means for satisfying these responsibilities." According to the preamble, this language has been added to address concerns that the "safe harbor" might be viewed as the exclusive rule for satisfying the ERISA prudence requirement applicable to DC annuity purchases."

8 The details of the illustration (e.g., interest rate and mortality assumptions) would be determined under rules promulgated by the Secretary of Labor, in consultation with the Secretary of Treasury. Importantly, these would only be illustrations: plans and plan fiduciaries would not be liable for payments in the amount illustrated under these rules, and the Department of Labor would be directed to provide model language to make this clear.

9 Any party responsible for QJSA administration and its attendant liabilities has sufficient motivation to ensure effective use of electronic security processes to safeguard participant and spousal rights.

10 See Munnell and Soto (2005) for a discussion of alternative methods of computing Social Security replacement rates.

11 In a prior paper (http://www.tiaa-crefinstitute.org/articles/tr070108.html), I defined this monthly income gap as being equal to the guaranteed monthly income minus essential expenditures, or the negative of the current definition. The current formulation is more natural in that it presents the income gap as a positive number.

12 When calculating this monthly income gap, it is very important to consider how income and expenditures will change over time. For example, Social Security income is indexed for consumer price inflation each January, whereas most private sector defined benefit plans and private sector annuity products are not. Given that most retiree expenses will rise over time due to inflation, it is important to consider the monthly income gap not only at the point of retirement, but also the size of this gap several decades into the future.

13 The precise number that one obtains for a Social Security replacement rate depends on a wide range of factors, including what one uses as an income base, what one assumes about retirement age, etc. Munnell & Soto (2005) offer a useful review of the issues involved. While estimates vary, the fraction of income replaced by Social Security for individuals near the middle of the income distribution is consistently under half.

14 The caveats include, but are not limited to, the fact that this analysis: (i) was conducted prior to the recent decline in financial markets, (ii) does not incorporate the likely changes in automatic enrollment and automatic escalation that may occur due to the passage of the PPA, (iii) includes IRA rollovers, which are excluded from the proposal above, and (iv) assumes that the account balance is used to purchase a fixed annuity rather than an escalating or indexed annuity. Further details on the assumptions of this model can be found in Holden and Vanderhei (2005).

15 The survivor rules for Social Security are complex, and thus the precise drop in income upon the death of a spouse varies depending on a variety of factors, including the relative ages of the spouses upon claiming and whether both spouses claimed benefits on their own record or whether one of the spouses received a spousal benefit. Those interested in more details on these rules can find a useful description on the Social Security website at *http://www.socialsecurity.gov/pubs/10084.html*

16 Finkelstein and Poterba (2004) provide evidence of selection by product type in the U.K. market.

17 For a discussion of the effects of extending working lives, see Social Security Advisory Board (2008).

18 Data on DC plan balances is from Table L.118.c of the Flow of Fund Accounts of the United States, released March 12, 2009. Data on IRA balances is from Table L.225.i. Both tables can be found on page 108 of the report, which can be found at http://www.federalreserve.gov/releases/z1/Current/z1r-6.pdf.

19 For a discussion of the structural problems facing the FDIC and the PBGC, see Brown (2008b) and Pennacchi (2009) respectively.

20 In other words, the first annuity contract is purchased using 1/5 of the account balance, the second contract is purchased with 1/4 of the remaining balance, the third contract is purchased with 1/3 of the remaining balance, the fourth is purchased with 1/2 of the remaining balance, and the fifth is purchased with all of the remaining balance.

21 A modification of this approach would be for the plan sponsor to begin purchasing a series of laddered deferred payout annuities several years before an individual's expected retirement date. For example, the plan sponsor could use 20 percent of the annuity account to purchase a deferred payout annuity contract at age 61 that would begin paying out at age 65. A year later, at age 62, the plan sponsor could purchase an additional contract deferred payout contract that would begin payments at age 65.

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