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Automatic Annuitization: New Behavioral Strategies for Expanding Lifetime Income in 401(k)s

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Introduction

Workers contemplating retirement face significant financial risks. Inflation, an uncertain rate of return on investments, the insolvency of a former employer or financial provider—all these external factors can deplete retirees' assets and income. Personal risks such as unemployment, illness, disability, and even life span can lower earning capacity or raise financial need.

A long life, a blessing in so many ways, is especially hard to manage. Some underestimate how long they will live or neglect to plan for the possibility of many years in retirement. Many find it difficult to devise and adhere to a plan for managing retirement assets over an uncertain, and potentially long, time horizon.

Americans' financial prospects for retirement naturally depend on how much money they have saved during their working years. Equally important, but often an afterthought, is how they use it.

Traditionally, the most complete solution to this problem has been to protect retirees from outliving their assets through the use of guaranteed lifetime income, such as an annuity. Annuities and other lifetime-income arrangements undertake to make predictable payments for as long as annuitants are alive.

Yet in recent years annuitization rates have fallen. Defined benefit pension plans at the workplace, a traditional source of low-cost annuity income, have increasingly offered and made lump-sum (single cash) payments, either by adding a lump-sum option to the plan's array of payout options or by converting the entire plan to a different, lump-sum-oriented format known as a hybrid. "Cash-balance" plans are the most common kind of hybrid. Many other employers have replaced their defined benefit plans with 401(k) plans, whose accumulated wealth is typically returned to workers upon retirement as a lump sum rather than as monthly payments for the duration of retirement. Only about 2 percent of 401(k) participants choose to convert their savings into annuities upon retirement.

Despite these trends, the need for stable and assured income has increased along with longer life expectancies and retirement periods. The choice between an annuity and a lump-sum distribution may be one of the most important

financial decisions a person ever makes. Why more people do not choose annuities has been something of a puzzle within the economics literature and for policy analysts. There are three broad classes of explanations:

—Annuities may not inspire confidence because they are not sufficiently transparent or simple to understand. Consumers find themselves mystified by annuities' complex provisions and worry (based partly on warnings in the personal finance and consumer protection literature) that insurance companies are pricing their products unfairly. Comparison shopping between annuities, let alone between annuities and lump-sum options, can be a lot more complicated than contrasting a Toyota to a Ford in an automobile showroom.

—Annuities may appear to be a risky, high-stakes gamble with insurance companies about how long the retiree will live. Retirees who die young are deprived not only of years of their life but also of years of annuity payments.

—Annuities may preclude important alternative uses of retirement savings.

An Automatic Strategy to Enhance the Appeal of Annuities

To encourage more retirees to put at least some of their retirement savings into lifetime income, it would be natural to consider the use of automatic (default) strategies. The intelligent use of automatic features in 401(k) plans has enjoyed striking success in expanding plan participation and improving investment behavior.[1] There is ample reason to think that the behaviorally inspired strategies that have worked so well to improve participation in 401(k) plans should be extended, as has long been intended, to 401(k) payouts as well.[2]

Currently the most common option in most 401(k) plans is the lump sum; retirees typically receive their savings in the form of a single check. For many retirees, this may not be the best choice. One way to promote a better choice is to make an annuity the default option at decision time. In the saving phase of financing retirement, automatic enrollment in workplace 401(k) plans has greatly increased desired behavior—in this case, saving for retirement. We believe the same principle can be put to work in the payout phase of retirement saving: deciding what to do with the accumulated savings. In a previous Retirement Security Project policy brief, Gale-Iwry-John-Walker (2008), put forward a single proposal providing that when retirees cash out their 401(k) plans, the accounts would automatically be used to support an annuity unless the retirees explicitly said they wanted a lump sum. [3] After receiving twenty-four monthly checks, retirees would be able to switch out and take the remaining value of their retirement savings in the form of a lump sum. Presumably, many would not do so.

Given the success of 401(k) automatic enrollment, would making an annuity the default option at retirement similarly increase the percentage of pension participants taking annuities? The evidence suggests it would not. Although a useful element in a strategy to encourage the selection of annuities, the default approach by itself would be far from sufficient. For example, every cash-balance pension plan is required by law to make a lifetime annuity the default method of payment, but the vast majority of participants in these plans opt out of the annuity in favor of a lump sum. In these plans, the benefit is framed as an account balance or lump sum; and even in traditional defined benefit plans, where the benefit tends to be framed as an annuity, participants often, though not as frequently, opt for a lump sum if it is available as an option.

The evidence suggests that when an annuity is the default and a lump sum is the alternative, most participants opt out of the default in favor of the lump sum, at least where the annuity-versus-lump-sum decision is presented as a momentous, all-or-nothing, irreversible decision affecting retirees' entire account balance. The force of inertia that gives the automatic or default strategy its power appears to be weak in these circumstances, and even weaker when the plan has framed the presumptive form of benefit as a lump sum. Could arrangements be designed to enhance the effectiveness of an automatic or default annuity and make participants more likely to accept it? We believe so.

Gale-Iwry-John-Walker (2008) discusses the factors limiting demand for annuities and outlines a promising proposal to increase demand for and participation in 401(k) plans: automatic trial income. Under this approach, which seeks to use inertia to overcome misconceptions about annuities, a 401(k) plan sponsor could tell retiring participants that half (or some other specified portion) of their account balance was tentatively earmarked for annuitization. The annuitization would begin with regular monthly payments for two years, unless the retiree opted out. At the end of the two-year trial period, retirees could elect an alternative distribution option; but if they did nothing, regular monthly payments would automatically continue for life. The underlying assumption is that once workers had an opportunity to "test drive" an annuity for a limited period of time and become accustomed to its advantages, they would be more likely at the end to accept it permanently. The regular income stream (or "pension paycheck"), rather than the lump sum, might come to be seen as the status quo or presumptive form of benefit.

We believe this automatic trial-income approach would go a long way toward addressing many of the obstacles to broader use of lifetime income in 401(k)s. However, it would not address all of them, and it would address some only to a limited degree, in part because it would apply mainly at the point of retirement (the start of the plan's payout phase). Accordingly, it may be that the use of lifetime income would be

expanded through a complementary approach that could be used in conjunction with the trial-income approach (or that could be offered to plan sponsors as another alternative, reflecting a similar behavioral strategy).

The complementary approach we have in mind would involve the phased or incremental acquisition of deferred annuities during the plan's accumulation phase. Like the trial-income approach, this strategy is designed to eliminate or mitigate significant obstacles to the expanded use of lifetime income, without purporting to remove all of the obstacles. Even as innovative product designs have recently come onto the market, each approach would help address an overlapping set of concerns. In combination, the Gale-Iwry-John-Walker (2008) trial income approach and the strategy outlined here are designed to address, in a mutually reinforcing manner, much of what currently limits 401(k) participants' demand for lifetime income.

Phased or Incremental Acquisition of Deferred Annuities

Based on our analysis of the factors inhibiting demand for lifetime income, a strategy that would make the automatic (default) approach a more powerful tool to promote lifetime income should incorporate three simple but important elements.

—*Avoid all-or-nothing decisions.* Instead of requiring retirees to use all, or none, of their savings to buy lifetime-income instruments, the new approach could allow them to use only a portion of their balance to purchase an annuity. New retirees could take possession of the balance of their retirement savings as a lump sum. The relative amounts of savings devoted to provide regular income and to fund a lump-sum payment would presumably vary from one household to the next depending on circumstances.

—*Avoid now-or-never decisions.* Plan participants could be allowed to choose incremental annuitization over time, rather than being confronted with a single moment of truth when the decision of whether or not to take an annuity is thrust upon them. The stress that accompanies making such a decision is not only unpleasant but also an incubator of bad decisionmaking. We would divide the decision not only in amount (through partial annuitization) but in time (through incremental annuitization).

—*Avoid never-or-forever decisions.* Today's practice generally forbids retirees to reverse any or all of an annuity purchase, at least for a while. This compounds the stress related to the initial decision; retirees who get it wrong do not have another crack at it.

These three elements effectively lower the stakes so that someone who passively accepts the default has almost nothing to lose. On any given day, the incremental cost of postponing an active decision and going along with the default is de minimis.

We would give effect to these three principles in a system in which a specified portion of worker and employer contributions to 401(k) accounts would be invested in units of deferred annuity. This portion would grow with time and with additional contributions. (This would not be the traditional deferred annuity that has often been used only as an investment vehicle, without ultimately being paid out in regular installments over the owner's lifetime. Instead, it would be designed mainly to provide lifetime guaranteed income beginning after retirement.)

Instead of making a single purchase decision at retirement, the employee would acquire an annuity incrementally, beginning either in mid-career (at age 45 or 50, for example,) or earlier, and continuing until retirement distributions began.[4] The employee could opt out of the arrangement entirely (although the default would be renewed from time to time, requiring an employee who was not interested in acquiring annuity-income units to opt out periodically). Alternatively, the employee could choose to dedicate a different percentage of current contributions to the incremental acquisitions.

Annuities' Advantages

Incremental purchases through regular, small contributions over a period of years should promote a fundamental reframing of the way 401(k) benefits are presented to participants. They would come to see the benefits not as a lump sum in a single account but as an income stream. They would regard each payment to them as a pension paycheck—deferred compensation for work done. The reframing could be accomplished in two ways: through regular benefit statements, and by accumulation. The benefit statement approach, which could apply in 401(k) plans and other defined contribution plans as well as to individual retirement accounts (IRAs), cash-balance plans, and other hybrid plans that present benefits as an account balance, is described in Gale-Iwry-John-Walker (2008):

> "To help reinforce a sense of ownership of the income stream rather than of only the lump sum, DC plan sponsors and IRA providers should be required to present the participant's benefits as a stream of monthly or annual lifetime payments in regular statements and in summary plan descriptions, in addition to presenting the benefits as an account balance in accordance with current practice. It may be possible to develop an industry-wide method of computing and presenting the stream
>
> "Over time, this change may help encourage account owners to become accustomed to thinking of their retirement resources as monthly income. Taking the distribution as monthly payments would seem "natural" – that is, it would be equivalent to maintaining the status quo. The intent is to reposition their frame of reference so that consumers do not feel a "loss" when they receive an income stream rather than a lump sum. Portraying the payments from

The incremental acquisition of annuity units would mitigate the interest rate risk associated with a point-in-time acquisition.

> an annuity as a consumption stream has been found to be a useful and more illuminating way of presenting the benefits of annuities. . . ."

The gradual acquisition of annuity-income units would also circumvent the wealth illusion or "sticker shock" that tends to discourage individuals from paying a "large" amount to an insurance company in exchange for an ostensibly "small" regular monthly payment. This is true for many of the same reasons that 401(k) payroll deduction contributions tend to work effectively as a saving mechanism: Participants would not see a large sum being transferred out of their account to an insurance company. Instead, they would pay small amounts over time, which should inflict little or no psychological pain. Incremental annuitization would avoid sticker shock not only because it is gradual but because it takes place years before the annuity is fully acquired, meaning that smaller contributions can be set aside to acquire the annuity given the additional time for tax-free investment earnings.[5]

Whether or not incremental accumulation of annuity-income units began by default, it would continue without requiring the participant to take any initiative or make any decision.[6]

Individuals confronted with the initial decision of whether to opt out of the gradual use of a portion of their contributions to acquire deferred annuity units would find the stakes at that moment to be low. It should be easier for individuals to accept the default with respect to any given contribution because it represents only a small amount. For example, whether to opt out of having 20 percent of current contributions automatically placed in a crelatively stable investment for the next few pay periods should not present itself as a momentous decision. (The plan might provide that, over the next five or ten years, the percentage would gradually, but automatically, increase to 30 or 40 percent.) Procrastination would be easy because the decision would be reversible. One could always decide to opt out later, before very much had been invested in the annuity units.

In addition, incremental acquisition could include an "unwind," or cash-surrender, option permitting the participant to opt out retroactively subject to a surrender charge. Such an unwind arrangement should be designed to encourage participants to engage in or accept incremental acquisition, because it is not irreversible, but should be set at a level that would discourage most participants from actually using it.

The incremental acquisition of annuity units would mitigate the interest rate risk associated with a point-in-time acquisition. Because individuals would face different interest rates throughout the purchase period, the rate in any single period would be averaged over time with other rates (much like an investment using dollar cost averaging).

For some participants, accepting the annuity-income default would mean

postponing receipt of much (for example, half) of their lump-sum distribution for two years. They might not be willing to defer gratification in this way. In fact, the evidence shows that the vast majority of retiring or terminating cash-balance plan participants override the default annuity in favor of a lump-sum payment. By contrast, participants in the accumulation phase might not perceive the incremental acquisition of annuity income as imposing a similar sharp trade-off or as requiring deferral of gratification.

Many plan participants may be drawn to the annuity option as a "safe" and stable investment, especially when markets are turbulent. While investors generally are warned not to act on emotion or attempt to time the market, many—especially those close to retirement—worry understandably during times of market volatility about the risk associated with equity investments. These individuals might welcome an investment strategy that is not centered on money market or stable-value funds (neither of which is a perfect solution). Investment in fixed annuities or in variable annuities with sufficient payout guarantees or floors could be part of the response to a potential and actual "flight to safety" in 401(k) plans.

Incremental acquisition of annuity income during the accumulation phase might be particularly responsive to these concerns. Fixed annuities or variable annuities with guarantees could serve as a "safe" investment composing a portion of a balanced, diversified portfolio. This particular advantage—the stability of a fixed or guaranteed annuity as an investment during periods of market volatility—is more likely to be demonstrated to participants over a decade or several decades of accumulation (spanning at least one market cycle, including at least one period of depressed or volatile market values) than at a particular point in time.

Holding Costs Down

For several reasons, the gradual acquisition of deferred annuities through an employer plan should also help reduce cost.

—Group annuities (or annuities purchased through a group purchase) are less costly than those purchased on the individual market because the group (through the plan sponsor) has greater bargaining power and can bring a greater degree of knowledge (including the help of an outside consultant) to the negotiating table.

—Group purchase should be less expensive insofar as it is less subject to adverse selection (although individuals with shorter life expectancies could be expected to opt out of the lifetime income approach and be underrepresented in the pool). But retirement annuities purchased earlier in life, when people have less information about their health status at retirement, might entail less adverse selection than purchase decisions at retirement and to that extent should be less expensive than annuities purchased at retirement.

—The deferral period should also reduce the perceived cost. A lengthy interval between purchase and payment means that the annuity value should have time to build up with investment earnings so that the annuity provider could offer a larger nominal monthly payment for each dollar of contributions.[7]

More generally, strategies such as the one outlined here – which could be used in conjunction with, or as an alternative to, the trial income approach described in Gale-Iwry-John-Walker (2008) — have the potential to expand the market sufficiently to make lifetime income a staple within the 401(k) universe. As discussed in Gale-Iwry-John-Walker (2008), this should lead to a better functioning market, with greater opportunities for standardization and transparency, and ultimately lower costs.

Implementing Incremental Acquisition

Typically 401(k) plans entail a strong framing of the benefit as a lump sum; indeed, the account balance itself can be and is viewed as a presumptive lump-sum benefit. It is not surprising, therefore, that only about 2 percent of 401(k) participants elect annuities. To compete with this deep-seated framing and strong participant bias in favor of lump sums, 401(k) plans could be required (as noted earlier) to regularly report accumulating benefits as an annuity equivalent, in addition to an account balance. (A similar approach might be considered for IRAs.) In fact, it might be especially useful to show the annuity equivalent at three alternative annuity starting ages, such as 62, 65, and 70. (This approach might encourage some workers to postpone retirement, depending in part on how they interpret the relative value of the higher annuity dollar amounts beginning at the later ages.)

In the specific context of 401(k) plans, two particularly promising vehicles could encourage participants to accumulate deferred lifetime income over the latter part of their working lives. We suggest these as alternatives, each of which may appeal to a different subset of plan sponsors.

Tapping the Employer Match

Most 401(k) plans provide employer matching contributions. A plan sponsor could make phased acquisition of annuity-income units more likely to occur (or ensure that it would occur) by dedicating its employer matching contributions to this purpose. A plan sponsor could choose to make such an investment mandatory or could make it the default, allowing participants to opt for a different investment. Either approach would be permissible under current law. The sponsor could even begin by using only a portion of the employer match to purchase annuities, gradually increasing to all of the match over time. The logic of a "bright line" segregation of employer matching contributions used to accumulate an annuity from other contributions invested in other ways should reinforce the "framing" of participant expectations that a portion of their account balance would be used to provide lifetime income.

We see three main potential advantages of using employer contributions in this way. First, the notion of the employer matching contribution being directed to a particular investment, either by dictate or by default, is a familiar one in the 401(k) universe. Traditionally, the prospect of obtaining Employee Stock Ownership Plan tax advantages, saving employer cash flow, enhancing worker incentives and productivity, and fending off hostile takeovers led many 401(k) plan sponsors to make employer contributions in the form of employer stock (or to provide for them to be invested in employer stock), subject, in many cases, to participants' ability to elect otherwise. Now that Congress has limited employers' ability to force investment of matching contributions in employer stock, there is an opportunity to use a similarly assertive approach with respect to the investment of employer contributions in the interest of expanding lifetime income.[8]

Second, participants who are skeptical about turning their assets over to an insurance carrier may be more accepting of "employer money" being invested in annuity income.[9] The difference between employers, as opposed to employees, bearing the cost of funding the benefits exists in employee and even employer perceptions, if not reality. (This policy brief does not explore the issues relating to the actual differences between employee and employer contributions, which are beyond the scope of this discussion.) Because employees and employers perceive an important distinction between employee and employer contributions, employees may feel that their employer is entitled to decide how "its own contributions" are used. This should be even more true in the case of employer nonmatching ("nonelective") contributions.

Third, this use of employer contributions avoids presenting the employee with an all-or-nothing choice and spares the employee the need to decide exactly what portion of his contributions to invest in deferred annuity units. Employer matching contributions often account for about a third of the account balance (or slightly less). To many employees, this might feel like a reasonable or acceptable portion to devote to lifetime income.

The accumulated annuity income units acquired with employer matching contributions could be used as an alternative to the two-year trial annuity proposed in Gale-Iwry-John-Walker (2008). Alternatively, plan sponsors might choose to use both approaches as default strategies. Plan participants who declined the investment of employer matching contributions in incremental annuity units might be willing to accept an automatic two-year trial annuity for a portion of their account balance at retirement, in part because of the earlier framing of a portion of benefits as a potential annuity. (However, for participants who accepted the investment of the employer match in annuity units, a two-year trial annuity is less likely to be necessary or appropriate; and plan sponsors purchasing annuity income for

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participants long before retirement may get a better price from annuity providers than those purchasing trial-income annuities.)

The employer contribution strategy may have special appeal to two types of plan sponsors. The first are companies that have previously made or invested employer contributions in employer stock and are now interested in reducing participants' (and the plan fiduciaries') exposure by reducing the amount of employer stock in the plan.[10] The second are those that have recently frozen, terminated, or otherwise reduced a defined benefit plan. Such sponsors often try to mitigate the expected loss to employees of an employer-funded defined benefit by making certain improvements in their 401(k) plans. To partially compensate employees for losing the advantages of the defined benefit, the sponsor might, for example, increase the employer match in the 401(k), add a nonmatching employer profit-sharing type contribution to the 401(k), or introduce automatic enrollment and automatic increases in employee contributions. Using employer 401(k) contributions to buy annuity-income units would have the advantage of replacing some of the expected retirement income that was lost when the company reduced its defined benefit plan.

Embedding Lifetime Income in a Life-Cycle Fund or Another QDIA

As an alternative to dedicating the 401(k) employer matching contributions to the phased purchase of lifetime-income units, plan sponsors and financial providers might consider incorporating the phased purchase of deferred annuity units into a qualified default investment alternative, or QDIA, specified by the Department of Labor. In regulations interpreting the 2006 Pension Protection Act, the Labor Department has specified several types of default investments that 401(k) and similar plans could offer without losing the degree of protection from fiduciary liability that results from allowing participants to select among certain investment options defined by the plan. Typically in conjunction with automatic enrollment, the 401(k) market has been moving briskly to incorporate these automatic or QDIA default investments.

Probably the most prevalent form of QDIA currently available is the target-date maturity fund, also known as the life-cycle fund. Often structured as a composite "fund of funds," the life-cycle fund generally holds a mix of asset classes, largely diversified equities, and fixed-income investments. A life-cycle fund for people who are decades away from retirement typically invests a majority of its assets in diversified stocks. As individuals approach their assumed target retirement date, the asset mix shifts gradually away from the potentially higher-return but higher-risk equities to a higher percentages of less volatile or more conservative investments such as bonds or other fixed-income investments (this process is often referred to as a "glide path"). Thus far, these target-date or life-cycle funds generally have been well accepted by employees as a means of achieving asset allocation and diversification that reflects a fairly broad consensus within the expert financial advisory community. [11]

The phased purchase of annuities would fit neatly into the life-cycle-fund rubric; and a new kind of life-cycle default fund could facilitate the phased purchase of annuities. The steadily growing fixed-income component of the life-cycle fund might be composed of fixed annuity-income units that accumulate over time and that would be paid out as an annuity at retirement. Thus, fixed deferred annuity units could substitute for the bond component of the life-cycle fund, either entirely or in part. (Whereas variable annuities are invested in equities, fixed annuities tend to be backed up, at least indirectly, by insurance company investments in bonds.) As a result, the percentage of 401(k) contributions being used to purchase deferred annuity-income units would grow as employees approached their expected retirement date. These new life-cycle or target-date funds would go beyond the funds currently offered insofar as they would not only serve as an investment but would also help participants manage the postretirement spend-down of their 401(k) assets.

If 401(k) plan sponsors chose to offer such funds, they would enlist inertia in the cause of persuading employees to allow a portion of their account balance to be invested in deferred annuities. Employees would have the usual ability to opt out of the default life-cycle investment fund. However, there is reason to expect that the current pattern with respect to conventional life-cycle QDIAs—a high rate of employee acceptance, as opposed to opt-outs—might well hold in the case of such new QDIAs. For most employees, the nonequity components of the default life-cycle fund are largely a "black box." Employees are unlikely to be highly sensitive to differences in the composition of the conservative portion of the asset mix, absent a meaningful reduction in expected return, a perception that the new type of investment was risky, or an increase in expenses. (This paper does not investigate potential expenses to plan sponsors or employees associated with the use of deferred annuities in standard QDIA investments.)

We obviously are not suggesting that annuities "stow away" in the currently popular life-cycle default funds without full and effective advance disclosure to participants. However, some of the same employees who might resist purchasing an annuity at retirement with their entire 401(k) account balance may be far more willing to accept partial deferred annuitization purchased incrementally—far more willing to accept the incremental choices involved in not opting out of a default life-cycle fund that includes deferred annuity units as its fixed-income component. Such a plan also would help them manage their assets after retirement and spread the risk that low interest rates at the time of purchase would reduce the amount of annuity that could be purchased with a given dollar of contributions.

Plans using this new kind of life-cycle fund as a QDIA could, of course, also offer other investment options including more conventional life-cycle funds that use fixed-income investments instead of annuity-income units. Conversely, the phased acquisition of deferred annuity

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units could be incorporated in any of the three principal QDIAs—not only the target-maturity or life-cycle fund but also balanced funds that do not change their asset mix over time, and managed accounts.

Complementary Approaches

The automatic phased or incremental annuity acquisition strategy could serve as an alternative to, or be used in coordination with, the automatic trial-income approach proposed in Gale-Iwry-John-Walker (2008).

First, viewing the incremental strategy as an alternative or a precursor to the trial-income annuity strategy addresses the fact that not all plan participants are in similar circumstances or are driven by the same considerations or concerns. Each approach might appeal to a different subset of the participant population; if each is effective with a different group, together they might encourage more lifetime income than either alone. In a rough, schematic way, table 1 shows the specific concerns inhibiting demand for lifetime income that

Table 1. How Policy Options Address Concerns Affecting Demand for Lifetime Income

√ = addresses concern to some degree √√ = strongly addresses concern

Concern/Obstacle	Trial Income	Phased Accumulation	Phased Accumulation Using QDIA or ER Match
I. Many Consumers Lack Confidence in Annuities: Not Sufficiently Transparent, Simple or Well Priced			
Lack of knowledge	√		
Mistrust	√√	√	√
Nontransparent costs			
High prices	√	√	√
Ostensibly unfav. terms of trade		√√	√√
Loss of sense of ownership	√	√√	√√
II. To Some Retirees, Choosing an Annuity Seems Risky			
Risk of losing to insurance co.	√	√	√
All or nothing choice	√	√√	√√
Irreversibility	√	√	√
Market timing interest rate risk		√√	√√
Insurance company insolvency			
III. Annuity Purchase Seems to Require Giving Up Important Alternatives			
Bequests	√	√	√
Liquidity	√	√	√
Financial flexibility	√	√	√
Loss of equity premium	√	√	√
Loss of investment control	√	√	√
Loss of current consumption	√	√	√

Source: Authors' compilation.
a. For a description and discussion of these concerns inhibiting demand as well as factors inhibiting the supply of lifetime income, see Jeffrey Kling and others, "Why Don't People Choose Annuities? A Framing Explanation," Research Brief (Washington: Retirement Security Project, March 2008).
QDIA = qualified default investment alternative.

are intended to be addressed by each of the two incremental purchase strategies described here (employer match and QDIA), by the Gale-Iwry-John-Walker (2008) trial period income strategy, and by a combination of these strategies. The table suggests that each of the strategies addresses a wide range of the issues that have been identified as inhibiting demand, and each appears likely to do better than the others in one or more areas. In the aggregate, they offer a range of possible strategies to plan sponsors, some of whom might feel more comfortable with one or another (or a combination) of these approaches.

Second, participants' choice (explicit or by default) to purchase annuity-income units for a period of years before retirement could make the trial-income approach more effective. While regular statements of benefits in annuity, as well as account-balance, form certainly promise to be helpful, they are only descriptive; reinforcing the effect of those statements through the incremental purchase of annuity-income units is experiential (as is the two-year trial of regular income) and thus potentially more powerful. Incremental annuity purchases would likely go far toward reframing participants' expectations regarding their plan benefits as an income stream rather than a presumptive lump-sum payment.

Third, a plan that has an incremental accumulation-phase element in its overall income strategy might, for example, make the actual commencement of annuity-income the default, but not mandatory, and combine the incremental option with the two-year trial approach. Participants who have accumulated annuity units might be more likely to go along with the initial default (preceding the two-year period) and experience the two-year trial, especially if the accumulated annuity units were used to provide the two-year trial payments. These participants might also be more likely to go along with the subsequent default (at the end of the two-year period), choosing permanent annuitization, again especially if accumulated annuity units were sufficient to fund some of those annuity benefits. (In fact, such participants might even ultimately annuitize portions of the account balance that do not represent accumulated annuity-income units.)

Fourth, plan sponsors may feel more comfortable actually requiring the two-year trial (rather than merely making it a default option) for annuity-income units that plan participants have purchased over a period of years on the understanding that they will presumptively be annuitized. The sponsor might, for example, allow participants to opt out of annuitization of such long-accumulated annuity-income units after the two-year trial period but may not feel constrained to offer the opt-out choice at the start of the two-year trial as well (assuming, as we do for current purposes, that the plan qualification rules would not require otherwise). As a result, more participants are likely to experience the two-year trial instead of opting out of it.

Annuities (whether acquired through trial income or incremental accumulation) may be more attractive to many households in times of economic turmoil, especially because fixed annuities can provide stability of investment returns, assuming the long-term solvency of the provider.

In addition, as discussed earlier, annuities (whether acquired through trial income or incremental accumulation) may be more attractive to many households in times of economic turmoil, especially because fixed annuities can provide stability of investment returns, assuming the long-term solvency of the provider. Incremental acquisition of annuity income during the accumulation phase may be particularly responsive to these concerns, insofar as the safety and stability of fixed annuities is likely to become more evident to participants over a long period of accumulation than during a two-year trial-income period.

New Product Features Address Some Key Concerns

Many concerns have been or are being addressed to some degree by traditional features or by innovations in annuity products or other competing financial products, although each additional feature inevitably comes at a price. Following are some examples.

—Variable annuities have long provided the option to make equity investments within an annuity and the option for the annuitant to exercise control over the investments (while exposing the annuitant to investment risk).

—Some of these products combine equity exposure with certain kinds of guarantees or floor values, including features that may lock in certain equity gains. The combination provides participants with upside potential together with a measure of protection against the risk of loss.

—Joint-and-survivor annuities that provide lifetime protection to an annuitant's surviving spouse, term-certain and life annuities that promise payments for a fixed number of years even if the annuitant is deceased, and annuities that provide lump-sum death benefits have been longstanding options designed to deal with annuitants' concern that an early death will leave the insurance carrier with most of their money. However, death benefits and cash-surrender options dilute the longevity risk protection by reducing the mortality credit for long-lived annuitants.

—Some annuities offer cash-surrender features that essentially allow annuitants or potential annuitants to change their minds and get much of their purchase price back, at least within a specified time frame, or allow partial ad hoc withdrawals to meet "economic shocks" or for other purposes. (However, annuity providers need to protect themselves against the risk of adverse selection by annuitants who discover their life expectancy has suddenly shortened.)

—Some annuities offer inflation protection for an additional premium. The inflation-protected annuity amount could be indexed to cost-of-living indexes or could increase by predetermined percentages designed to provide rough, partial inflation protection.

—Mutual funds and other financial institutions outside the insurance industry have developed products that

provide regular monthly income at a predetermined or variable level, with greater flexibility than many annuity products but without the lifetime guarantee or longevity risk sharing of a life annuity.

Many of these results can be achieved simply by purchasing an annuity with only a portion of one's retirement savings and using the remainder to provide survivor protection, equity investment opportunities, spending flexibility, inflation protection, and the like.

Several insurance companies are offering products to 401(k)s that would permit participants to purchase deferred annuity units on an incremental basis. However, these products have yet to be widely adopted. We believe that strategies such as those described here and in Gale-Iwry-John-Walker (2008) may be needed to spark greater employee demand for lifetime income – including the use of employer matching contributions to fund deferred annuities, QDIAs to incorporate deferred annuities, and a "trial income" arrangement to try out annuities. We are encouraged to learn that one provider has gone to market with a product that embeds an annuity in a life-cycle fund, similar to the concept outlined above.

Solving the Portability Problem

The strategy outlined here raises a number of important issues and confronts several key challenges. The most significant challenges are how to

—ensure reasonable portability of the lifetime income arrangement as employees change jobs;

—ensure that the cost of the annuity or other lifetime income is reasonable, given market imperfections;

—manage the risk that the annuity provider will become insolvent or otherwise go out of business during the many decades over which the individual will be relying on the lifetime income promise; and

—protect plan sponsors from undue fiduciary risk, while protecting employees from unduly risky lifetime income providers or arrangements.

We address the first of these issues below because the portability problem is generally unique to the preretirement accumulation strategy outlined here. The other three issues are discussed in Gale-Iwry-John-Walker (2008), as they are also raised by the post-retirement trial income approach outlined there. In addition, using 401(k) plans as a vehicle in the manner described here raises a variety of regulatory and other issues, including unisex pricing of annuities and the application of the survivor protection and spousal consent requirements. [12] We intend to pursue these issues in future work and hope others will do so as well.

The phased or incremental acquisition of deferred annuities presents a significant challenge to pension "portability."

Participants in a 401(k) who begin to accumulate a deferred annuity and then leave their job often have no opportunity to continue their 401(k) accumulation. The employee who takes a new job would be unable to add to the annuity-income units unless the new employer offered a 401(k) plan that happened to offer a comparable annuity accumulation opportunity with the same provider—not a high probability—and that was willing to accept a transfer or rollover of the previously accumulated units. If the accumulated amounts were small, either or both the employee and the new employer might question whether it was worth the administrative burden to take them as rollovers and whether expenses would threaten to erode their value over time. Some might argue that the portability concern militates in favor of providing that larger amounts of contributions be defaulted toward incremental purchase of annuity units. However, this would help only to the extent amounts had accumulated over a sufficient period, and it might well reduce participants' willingness to go along with the default. Before suggesting potential solutions, it is worth noting that the magnitude of the portability problem, while considerable, should not be overstated. First, incremental accumulation of lifetime income, as proposed here, generally would not begin until middle age. By that point in a worker's career, the typical frequency of job changes has declined significantly, especially for employees covered by a 401(k) plan. [13] Second, the prospect of receiving lifetime income from several providers, as opposed to a single, consolidated source, is messy but not impossible or necessarily ineffective. Retirees fortunate enough to have accrued benefits under more than one defined benefit plan may be in a similar situation.

Several approaches might mitigate this potential lack of portability:

Top up or tap out. Beginning with arrangements that are currently in effect, some employees could "top up" a deferred annuity account by making an ad hoc transfer of assets from other 401(k) or IRA investments. Topping up might be effective in some circumstances, but many workers will lack other resources that would be available for this purpose. For those who have the resources, counting on them to top up would depart from the "behavioral" assumptions and strategy outlined here by requiring employee initiative to make what may be a difficult decision.

As a last resort, deferred annuity accounts that are deemed unlikely to grow and too small to be worth annuitizing might be converted to other investments. This approach may be similar to accumulating funds in an account for future purchase of annuity units only if and when the account reaches a designated critical mass. Such an approach might be viewed as giving the employee a claim to purchase future annuity income rather than actually purchasing the future income. However, it is unclear how much of a difference there would be between a purchase with a surrender option and a claim with a purchase option. In either case, the funds would need to be appropriately invested in the meanwhile and, to give

the employee the benefit of interest-rate averaging, steps would need to be taken to lock in interest rates during the interim period. The degree to which a more tentative or contingent arrangement, short of the actual purchase of annuity units, would be more efficient and worth doing presumably would depend largely on the transaction costs of surrendering and liquidating the small annuity-income accumulation. (This issue is somewhat analogous to the question, discussed in Gale-Iwry-John-Walker (2008), of whether the two-year trial income should constitute the first 24 monthly payments of an annuity purchased from an annuity provider and subject to surrender after 24 months or is better structured as a 24-month installment paid directly by the 401(k) from the assets held in the individual's account.)

IRA rollover. Another alternative that can be pursued using arrangements currently in effect is to roll over the original deferred annuity to an IRA (in this case, an individual retirement annuity). The IRA would be sponsored by the same annuity provider that provided the 401(k) accumulation annuity and would offer a similar option to invest in deferred annuity units. Individuals could then continue contributing to build up their deferred annuity. Yet for many people the IRA contributions would "compete" with the opportunity to contribute to a new employer's 401(k) plan. The terms of that competition could be unfavorable to the IRA insofar as

—the employee's 401(k) contributions typically would be matched by the employer up to a specified percentage of pay;

—the employee would be entitled to an exclusion from income or tax-favored Roth treatment for contributions to the 401(k) but might not be eligible for a corresponding IRA deduction or Roth IRA treatment for contributions to the IRA; and

—absent the regular payroll deduction mechanism used in 401(k) plans, the contributions to the IRA would be unlikely to begin or continue automatically and therefore would be less likely to be made.

Greater standardization. Widespread adoption of similar arrangements in 401(k) plans could mitigate the portability problem. However, this would likely be effective only to the extent that annuity providers were willing to facilitate like-kind exchanges of annuity products that allowed individuals to transfer and consolidate deferred annuities with a single annuity provider in a manner analogous to rollovers to IRAs. This in turn would seem unlikely to be efficient or to minimize transaction costs unless providers offered sufficiently homogeneous products. Standardization would be in tension with competitive innovation and, to some degree, with the offering of annuity features designed to respond to consumers' desire for greater flexibility and risk protection (such as death benefits, surrender options, inflation protection, and the ability to share in potential equity returns).

These obstacles might be addressed through a structured marketplace or platform on which competing income-accumulation products could be offered to plan sponsors. Products would be

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permitted to compete on the platform on condition that they met specifications assuring uniform features, price transparency, and sufficient transferability among products to achieve reasonable portability. At least one private firm offers a somewhat similar arrangement to plan sponsors, which makes it easier to offer and compare annuities for retiring employees. Ultimately, providers might be encouraged to participate in consolidated, standard industrywide products that would not only facilitate portability but spread insolvency risk among all participating providers. In view of these features, such omnibus multiprovider arrangements might qualify for some form of federal government reinsurance or guarantee that would be more uniform and effective than existing state guaranty funds (see Gale-Iwry-John-Walker (2008).

A multiprovider product that spread insolvency risk could also make plan sponsors more willing to offer lifetime income options by significantly reducing the fiduciary risk they otherwise face when choosing among annuity products offered by competing providers. If implemented on a large scale, such an arrangement would increase manyfold the odds that an employee moving to a new employer could continue accumulating deferred income units.

Conclusion

With increased reliance on 401(k) plans, an important challenge facing the U.S. retirement system is how to help retirees manage the risk of outliving their assets. In the past Americans frequently met this problem using private pensions that guaranteed a particular monthly benefit for life. That approach shifted risk onto employers, many of which reacted by replacing defined benefit pension plans with 401(k) plans, which define a particular contribution, leaving it to the workers to invest that money well and to figure out how to use it to see them through their retirement years.

Each of the "automatic" or default strategies outlined here—including acquiring lifetime income incrementally through the use of employer contributions or embedding a deferred annuity in a QDIA, as well as the Gale-Iwry-John-Walker (2008) automatic trial income proposal —is designed to draw on experience and insights from behavioral economics to help replicate, within the 401(k), one of the valued features of the traditional defined benefit pension. That feature is guaranteed lifetime income at group rates (combined, in most cases, with professional investment management).

We do not hold the view that annuitization of 401(k) balances is necessarily appropriate for all 401(k) participants. We do believe, however, that biases and other obstacles to lifetime and other long-term income options are responsible for the low annuitization rate. This policy brief presents a strategy for reducing those obstacles and thereby improving retirement security. Further work is needed to resolve a number of significant issues relating to cost, solvency protection, portability, employer fiduciary responsibility, and other implementation questions.

Notes

1. Brigitte C. Madrian and Dennis F. Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics 116, no. 4 (2001), pp. 1149–87; William G. Gale and others, "Improving 401(k) Investment Performance," Issue Brief 2004-26 (Boston College, Center for Retirement Research, 2004); William G. Gale and J. Mark Iwry, "Automatic Investment: Improving 401(k) Portfolio Investment Choices," Policy Brief 2005-4 (Washington: Retirement Security Project, 2005).
2. A related goal would be to encourage portability through rollovers. This related topic is addressed by J. Mark Iwry and David C. John in, "Pursuing Universal Retirement Security Through Automatic IRAs," Policy Brief 2007 – 2 (Washington: Retirement Security Project, 2007).
3 Gale, William G.; Iwry, J. Mark; John, David C. and Walker, Lina. "Increasing Annuitization in 401(k) Plans with Automatic Trial Income." The Hamilton Project, Discussion Paper 2008-02, June 2008.
4. Ideally, employees who change employers between age 45 or 50 and retirement would continue their gradual acquisition of annuity-income units, but they generally would find it more cumbersome to do so.
5. A thoughtful experiment by Jeffrey Kling and others, "Why Don't People Choose Annuities: A Framing Explanation," Research Brief (Washington: Retirement Security Project, March 2008), provides some evidence that consumers might respond positively to framing annuity benefits as a consumption stream rather than as an investment. The reframing we propose, especially by embedding the annuity purchase in the life-cycle or balanced default fund (QDIA), presents the annuity both as a secure and convenient income stream and as an attractive investment. There is no need to run away from the investment dimension of a deferred annuity that is assigned its "rightful" place in an asset-allocated portfolio (whether self-constructed or a balanced or life-cycle fund). We believe that the deferred annuity that makes up only a portion—potentially the fixed income portion—of a diversified portfolio can be effectively presented as such to consumers while also touting its advantages as a secure and predictable income stream after retirement. In addition, framing a deferred annuity as a default incremental purchase opportunity applicable to a portion of current 401(k) contributions should increase the likelihood of acceptance by plan participants. We would welcome further experimentation by Kling and others, building on the excellent work they have done thus far, to test this hypothesis.
6. This approach has similarities to some plans offered through TIAA-CREF (Teachers Insurance and Annuity Association, College Retirement Equities Fund), an insurance company which is a major retirement provider for academics and teachers. In the TIAA plans, workers generally incrementally purchase units of annuities while they are working, rather than making a single annuity purchase at retirement.
7. By the same token, the lengthy deferral period may require protection against inflation (at least unless the deferred annuity is a variable annuity, invested largely in equities, which entails greater risk). The deferred aspect of an annuity purchased gradually with contributions resembles the deferred annuity sometimes known as longevity insurance, which may be purchased at retirement but does not begin payment until an advanced age, such as 85.

8. As a broad generalization, we believe that 401(k) participants on average would be better served by less employer stock and more lifetime income.
9. Economic analysis suggests that, in the long run, most employer contributions and benefits can be expected to come out of the overall employee compensation package, and thus most of the cost might ultimately be borne by employees. The extent and timing of this shift, however, depend on the company's specific circumstances, including the dynamics of the labor market. Labor and management tend to take it for granted that, at least in the short run, there is an important difference between "employee" and "employer" contributions in many situations.
10. For more on the risks of excessive concentration in employer stock, see J. Mark Iwry, "Promoting 401(k) Security," Tax Policy Issues and Options 7 (Washington: Urban-Brookings Tax Policy Center, September 2003); Gale and others, "Improving 401(k) Investment Performance"; and Gale and Iwry, "Automatic Investment: Improving 401(k) Portfolio Investment Choices."
11. Katie Benner, "Life-Cycle Funds Not a Retirement Cure-All," TheStreet.Com, Sept. 4, 2006, notes that most of the clients of T. Rowe Price that use automatic enrollment use life-cycle funds as the default investment.
12. Regulatory issues are described in two very thoughtful papers by Robert Toth: "Distributing Annuities from Defined Contribution Plans: The Qualified Plan Distributed Annuity," CCH Pension Plan Guide, Benefit Practice Portfolios (Riverwoods, Ill.: CCH Incorporated, June 2008); and "Annuitizing from 401(a) Defined Contribution Plans: A Technical Overview" ERISA Compliance and Enforcement Strategy Guide (Washington: Bureau of National Affairs, July, 2008).
13. Alan L. Gustman and Thomas L. Steinmeier, Pension Incentives and Job Mobility (Kalamazoo, MI: Upjohn Institute, 1995).

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Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

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