

Allowing Retiring Employees to “Test Drive” an Annuity

by Melissa Kahn and Jody Strakosch

If defined contribution (DC) plan sponsors haven't already done so, they soon will be giving serious consideration to providing retiring plan participants with options to convert at least a portion of their savings into retirement income. Only time will tell whether employers will be *encouraged* to make those options available to participants or *required* to do so. Either way, *trial annuitization*—a concept that builds on the DC industry's success with automatic enrollment and automatic increase—is worth exploring further and may be a concept whose time has come.

Changing demographics and the shifting retirement landscape present current and future generations of retirees with significant challenges. Many U.S. workers are at risk of not having adequate retirement income, and the difficult economic environment has only exacerbated the problem.

The move from traditional defined benefit (DB) plans, which typically accrue benefits for workers based on years of service and earnings, to defined contribution (DC) plans such as 401(k) plans, in which participants finance their own retirements, has shifted the burden of retirement savings from employer to employee. Yet, DC plans generally were never intended to serve as employees' primary source of retirement savings, nor were they designed to provide guaranteed lifetime income.

Today, employers are grappling with the challenge of ensuring that the money their employees saved in these plans is managed so that individuals do not outlive their savings. One of the most important decisions employers are contemplating right now is how

to help 401(k) plan participants convert a portion of their retirement savings into guaranteed lifelong income. This shift in focus is generally thought of as “changing the conversation” with employees to help them recognize that DC plans now need to be thought of as “retirement income” plans.

ACCESS TO ANNUITIES AS A DISTRIBUTION OPTION IS LIMITED

Although the majority of workers today are covered by DC plans, nearly 86% of these plans do not offer the option to annuitize assets when workers retire, according to *Hewitt's Trends and Experience in 401(k) Plans 2009* (Hewitt Associates, 2009). Many plans have eliminated the annuity distribution option for a number of reasons. Chief among them are fiduciary liability concerns and the administrative issues related to offering annuities.

The uncertainty of plan sponsors' precise fiduciary duties when offering annuities to their workers has historically been a chief deterrent to including annuities as a distribution option. In October 2008, the U.S. Department of Labor (DOL)—as directed by the

TYPES OF ANNUITIES

Annuities come in a variety of forms, and new products are being developed by the insurance industry. Well-known annuity products include

- **Single-life annuity:** Provides fixed monthly benefit payments guaranteed for life. No survivor benefit is paid after the annuitant's death (also called a *straight-life annuity*).
- **Joint and survivor annuity:** Provides fixed monthly benefit payments guaranteed for life and, upon the annuitants' death, continues partial payments to the surviving spouse or other beneficiary for the rest of his or her life.
- **Inflation-indexed annuity:** Provides monthly benefit payments guaranteed for life that increase to keep up with inflation. Annual increases may be cost-of-living increases or linked to the Consumer Price Index.
- **Variable annuity:** Provides monthly benefit payments guaranteed for life that may increase or decrease based on performance of underlying investments the purchaser selects.
- **Deferred annuity:** Monthly benefit payments are purchased over time but are not scheduled to begin until a person retires and then are guaranteed for life.
- **Longevity annuity:** A type of deferred annuity generally purchased at the time of retirement that provides a guaranteed stream of income typically starting after a late age, such as 85.

Source: U.S. Government Accountability Office, July 2009.

Pension Protection Act of 2006 (PPA)—issued a final regulation that clarifies the fiduciary standard as it relates to the selection of an annuity provider for the purpose of benefit distributions from individual account plans such as 401(k) plans. The regulation, which is structured as a safe harbor, sets out clear factors that should be used in assessing the annuity provider's ability to make future payments under the contract and in reviewing the costs of the annuity in relation to the benefits and services provided under the contract.

ANNUITIES, WHEN OFFERED, OFTEN OVERLOOKED

In the small percentage of plans that do allow participants to annuitize, most participants continue to take the lump-sum option. Only about 1% of 401(k) participants choose to convert their savings into annuities upon retirement, according to Hewitt Associates. It's unfortunate that participants often overlook annuities at the point of retirement.

The chief advantage of an income annuity is that it provides guaranteed lifetime income. Annuities are the only product that can pay guaranteed income for life; no other product can offer this benefit. Academics generally say that putting money into an annuity can help a person meet basic expenses in retirement.

Another key advantage of income annuities is that they generally have the ability to produce the highest level of guaranteed income per dollar of assets, which provides the annuitant with the ability to maximize income. For example, an average retiree would need to save about one-third more to replicate the power of the lifetime income annuity. With this taken care of, remaining assets can be more efficiently invested to potentially grow an individual's overall portfolio. While a retiree trades off a bit of liquidity for the portion of assets put into an annuity, he or she likely will have more income to spend overall.

Putting these advantages together means that income annuities can perform the double task of maximizing current income, while also avoiding the risk of running out of money later.

Annuities are ideally suited for the large majority of individuals. Individuals cannot self-insure the risk of outliving their money because they cannot accurately predict how long they will live. Whereas an individual can decrease his investment risk by changing his investment strategy, there is no way that an individual can, on his or her own, reduce longevity risk.

Furthermore, the *2009 MetLife Study of the American Dream* found that without a steady paycheck, 50% of Americans say they could not meet their financial obligations for more than a month. Of that, a disturbing 28% couldn't support themselves

for more than two weeks of unemployment (MetLife Inc., 2009a).

As employers consider whether to offer DC plan participants the ability to create retirement income at the point of retirement, public policy makers are paying lots of attention to these issues. Most recently, DOL and the U.S. Department of the Treasury issued a request for information to explore, among other issues, ways to increase lifetime income and/or annuitization so that 401(k) plan participants have an opportunity to convert at least a portion of retirement savings into lifelong income.

AUTOMATIC TRIAL INCOME GAINING ATTENTION

One concept gaining attention is automatic trial income at the point of retirement—often referred to as *trial annuitization*. This concept of *auto income* builds upon the success the DC industry has seen with automatic enrollment and automatic increase. These concepts, endorsed by PPA, acknowledge the powerful role of inertia. Common wisdom—and many studies—inform us that participants don't take the appropriate actions to provide themselves with the best outcomes. Participants often say, "Please do it for me."

The general idea of trial annuitization is that allocating a portion of a retiring employee's plan assets automatically into a lifetime income annuity at the point of retirement essentially gives retirees an opportunity to "test drive" the benefits of receiving a retirement income "paycheck." And, as previously stated, we know that Americans depend on their paychecks to meet financial obligations.

A paper released in 2008 by the Retirement Security Project, a Washington, D.C.-based think tank, entitled "Increasing Annuitization in 401(k) Plans with Automatic Trial Income," sets forth a proposal that would increase the role of lifetime income products, such as income annuities, in an effort to help retirees enjoy a secure retirement.¹ The authors explained that automatic features in 401(k) plans have shown that the power of inertia can be used to significantly improve outcomes without restricting retirees' choices.² Specifically, the paper proposes the following:

- A substantial portion of assets in 401(k)-type accounts (generally considered to be no more than 50% of the account balance) would be automatically directed into an income program for a two-year trial period (the default trial arrangement), unless workers affirmatively elect a different form of payout permitted under the retirement plan.

- There would be trial income of 24 consecutive monthly payments.
- After the trial period, participants would regain the ability to opt for alternative forms of payment. Those who made no affirmative choice within a specified period would continue to receive income payments because the program would convert automatically from trial-period income to permanent income.

Under the Retirement Security Project proposal, plan sponsors could choose to administer the payout of the income program or arrange for an outside provider to offer it. Plan sponsors could determine the portion of the account balance that would be subject to the default trial-period income option and would also choose the provider or providers and type of default trial income and post-trial income products, subject to regulatory guidelines.

University of Illinois Professor Jeffrey R. Brown in 2009 made a similar proposal, entitled "Automatic Lifetime Income as a Path to Retirement Income Security." He suggested that employers be encouraged to adopt an automatic annuitization plan under which, when an employee makes an initial request for a (nonhardship) withdrawal from a DC plan, the employee would be notified that he or she is being automatically enrolled into a (partial) annuitization program. The program would convert half of the par-

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ticipant's total 401(k) account balance into a joint and 100% survivor annuity for a married person or a single life annuity for an unmarried individual. These annuities could be immediate annuities subject to a trial period, 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.

One of the most important decisions employers are contemplating right now is how to help 401(k) plan participants convert a portion of their retirement savings into guaranteed lifelong income. This shift in focus is generally thought of as “changing the conversation” with employees to help them recognize that DC plans now need to be thought of as “retirement income” plans. ◀

One potential way that plan sponsors can ensure financial readiness in retirement is to take “control” of the employer match. Sponsors could use this trial income concept for their match, thereby ensuring that employees will have a baseline of retirement income. This follows along the philosophical lines of DB plans, yet as with all automatic default programs, participants may opt out if the trial income is not the best solution for their situation.

Interestingly, in its *2009 Study of Employee Benefits Trends*, MetLife found that 50% of surveyed employees voice an interest in their employers providing ways to convert retirement plan lump sums into income for life. On the other hand, only 21% of employers have expressed interest in having their company provide solutions that accomplish this goal (MetLife Inc., 2009b).

As millions of American workers are approaching retirement, ensuring that they don't run out of money in retirement has become a major societal and workplace issue. Whether the specific concept of *trial annuitization* will have the imprimatur of the Obama administration remains to be seen. What is clear is that plan sponsors, if they haven't already done so, will soon be giving serious consideration to the ways in which their plan participants will be able to convert at least a portion of their savings into retirement income. Only time will tell whether employers will be *encouraged* to make those options available to participants or *required* to do so. Either way, trial annuitization is a concept worth exploring further, and it may be a concept whose time has come. ◀

Endnotes

1. The Retirement Security Project is supported by the Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

2. The study's authors are William G. Gale, director of the Retirement Security Project and the Arjay and Frances Miller Chair in Federal Economic Policy at the Brookings Institution; J. Mark Iwry, now senior advisor to the secretary of the Treasury, deputy assistant secretary for retirement and health policy for the Office of Tax Policy; David C. John, managing director of the Retirement Security Project and a senior research fellow with the Thomas A. Roe Institute for Economic Policy Studies at the Heritage Foundation; and Lina Walker, now strategic policy advisor with AARP's Public Policy Institute.

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