BNA Insights

Annuities

Policymakers Can Help Retirees Achieve Lifetime Financial Security

BY FRANK KEATING

Introduction

Over the next two decades, 77 million baby boomers will enter retirement, a phase of their lives which could last 30 years or more. Yet many baby boomers have serious doubts about whether they will be able to effectively manage their retirement savings as they age and whether their savings will sustain them comfortably.

Due to increasing lifespans, changes in employment-based pension plans, economic volatility and an information gap, retirees face a substantial risk of outliving their private retirement savings, forcing them to rely exclusively on Social Security to address their day-to-day and month-to-month expenses.

These retirees may become burdens on the government and the next generation of taxpayers if their resources fall short of what is required to provide basic living needs. American workers are looking to their employers for information on the risk of outliving their assets and ways to address it.

Lifetime annuities offer retirees a means to mitigate this risk. By using a portion of their retirement assets to purchase a lifetime annuity, retirees can guarantee monthly income for the rest of their lives. No other financial product, nor strategic layering of other products, can match the lifetime annuity guarantee. Moreover, research shows that unlike alternative strategies, lifetime annuities can protect retirees from substantial declines in their standard of living at older ages.

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In a request for information (RFI), the Labor and Treasury Departments are seeking input on whether they should encourage employer-provided defined contribution plans to include lifetime income products as distribution options, and on ways to do so (85 PBD, 5/5/10; 37 BPR 1083, 5/11/10).

In addition, Labor and Treasury are seeking information on ways to provide workers with better information about longevity risk. Technical reforms in existing pension law, combined with carefully-crafted incentives, can help employers and workers understand this risk and prepare for it through lifetime annuities.

What Are Annuities?

Annuities are insurance. While many annuities offer consumers investment options, the distinguishing feature of an annuity is insurance, or transfer of risk. In the case of annuities, an individual, usually a retiree, seeks to transfer the risk of outliving his or her assets to an insurance company.

The retiree pays the insurance company an upfront premium—which can be either a lump-sum or a stream of payments—and in return the retiree receives a guarantee of monthly income for life paid by the insurance company. In the case of a basic lifetime annuity, this income will not vary based on economic conditions or volatility in the financial markets.

It is often said that while life insurance protects consumers from the financial risk of dying too soon, annuities protect consumers from the financial risk of living too long. The guarantee is the heart of an annuity. In addition, a basic lifetime annuity protects consumers from market risk. While strategic layering of mutual funds may help reduce downside market risk, there is no guaranteed protection.

The Retirement Income Time-Bomb

The baby boom generation is seriously unprepared for retirement. . .and baby boomers know it. Only 29 percent of American workers say they are "very confident" about having enough money to pay for basic ex-

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penses during retirement.[1] Moreover, the percentage of workers who expect to work beyond age 65 has increased dramatically, from 11 percent in 1991 to 33 percent in 2010.[2]

Without making serious reductions in their standard of living, 60 percent of new retirees can expect to outlive their financial resources. Near retirees, defined as workers seven years or fewer away from their expected retirement date, would have to reduce their standard of living 45 percent to minimize the likelihood of outliving their assets, unless they have a guaranteed source of income beyond Social Security.[3]

A major reason is the dramatic change in the nature of employer-provided retirement plans. In 1980, 30.1 percent of American workers participated in a defined benefit plan, which generally provides lifetime income to retirees. Only 18.9 percent participated in defined contribution plans, which leave to workers the responsibility for management and distribution of retirement assets.

By 2004, the percentage of workers participating in a defined benefit plan declined to 20.6; while the percentage participating in defined contribution plans climbed to 52.2.[4] This trend is likely to continue. Because employer payments into defined contribution plans can be fixed as a predictable share of payroll, employers can reduce balance sheet and earnings volatility that is inherent in defined benefit funding.[5]

Moreover, life spans increased dramatically during the past century, meaning that workers are spending a greater percentage of their lives in retirement. In 1900, the average life span was 47.9 years for men and 50.7 years for women. By 2004, the average life span reached 75.2 years for men and 80.4 years for women.[6]

A married couple with guaranteed income beyond Social Security, such as a defined benefit plan or annuity, making $75,000 at retirement has a 31 percent chance of outliving their other retirement assets if the couple retains its pre-retirement standard of living. By contrast, a couple that has Social Security as the only source of guaranteed income has a 90 percent chance of outliving their other retirement assets.[7]

Moreover, the situation is likely to get worse. "Unless workers aged 55 to 59 increase their saving substantially or work beyond age 65, they will be unable to maintain their current standard of living and will have to reduce their standard of living significantly more than today's retirees to minimize the risk of exhausting their financial assets."[8]

Once personal retirement savings are exhausted, the only guaranteed source of income for most retirees is Social Security, which pays an average monthly benefit of $1,153.[9]

It was against this background that the Treasury and Labor Department recently published a Request for Information asking for input on whether the agency should facilitate access to lifetime income arrangements for retirees, particularly those covered by defined contribution plans.

> "Accordingly, with the continuing trend away from traditional defined benefit plans to 401(k) defined contribution and hybrid plans, including the associated trend away from annuities and towards lump sum distribution, employees are not only increasingly responsible for the adequacy of their savings at the time of retirement, but also for ensuring that their savings last throughout their retirement years and, in many cases, the remaining lifetimes of their spouses and dependents."[10]

In a subsequent *BNA Insights* article, ACLI will discuss specifics ways to expand the availability of lifetime annuities in defined contribution plans. The balance of this article focuses on why federal policymakers should act, and act soon.

Better Information/Options Sought

ACLI commissioned the independent research firm of Mathew Greenwald & Associates to evaluate whether workers aged 45 to 65 who participate in defined contribution plans (a) want their employers to offer additional options for distribution of their retirement plan assets, including lifetime annuities, and (b) would like to receive an illustration of how their lump sum retirement assets translate into a guaranteed stream of monthly income.[11]

The online survey included 750 workers with defined contribution account balances of at least $40,000 and no defined benefit pension plans. The results showed that more than 90 percent of respondents believe it would be valuable to have their employers show them an illustration of how much guaranteed monthly income they could receive based on the current value of their retirement plan accounts, with more than 50 percent saying this would be "very valuable." Similarly, 85 percent said they would be interested in receiving this information regularly.

Some 60 percent of respondents said that if this illustration showed that the monthly income would not be enough to meet their needs, they would start saving more immediately.

An overwhelming majority, nearly 90 percent, said they support employers offering a retirement plan option that would provide for guaranteed lifetime income.

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[1] The 2010 Retirement Confidence Survey: Confidence Stabilizing but Preparations Continue to Erode, Helman, Ruth (Mathew Greenwald & Associates) and Copeland, Craig and Van Derhei, Jack (Employee Benefit Research Institute), Employee Benefit Research Institute, March 9, 2010.

[2] *Id.*

[3] Retirement Vulnerability of New Retirees: The Likelihood of Outliving Their Assets, Ernst & Young LLP for Americans for Secure Retirement, July, 2008 (Updated June 2009) *(Disclosure note: ACLI is a member of Americans for Secure Retirement).*

[4] United States Department of Labor, *Private Pension Plan Bulletin, Historical Tables,* March 2007.

[5] The Shift from Defined Benefit to Defined Contribution Pension Plans – Implications for Asset Allocation and Risk Management; John Broadbent, Michael Palumbo and Elizabeth Woodman; Bank for International Settlements, December 2006.

[6] United States Centers for Disease Control and Prevention, *Life Expectancy,* FastStats, updated May 15, 2009.

[7] Ernst & Young, *op cit.*

[8] *Id.*

[9] Social Security Administration, *2009 Social Security Changes.*

[10] Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, Department of the Treasury and Department of Labor, *Federal Register, Vol. 75, No. 21 (Feb. 2, 2010), pages 525-5258.*

[11] ACLI Retirement Choices Study, *Online Survey with Near-Retiree Defined Contribution Plan Participants,* Mathew Greenwald & Associates, April 2010.

The same percentage said that if their employer offered this option, they would be interested in learning more about it.

Respondents also said they believe employers should help employees prepare for retirement. Indeed, 70 percent said they disagree with the statement that employees know how to use their savings to generate retirement income for themselves and don't need an option from their employers to do it for them.

In addition, 50 percent of respondents said they disagree with the statement that "employers have no responsibility for helping employees determine what to do with their retirement savings after they retire."

Interestingly, the survey found that workers' have less confidence in their ability to manage the distribution of their retirement savings than manage the accumulation. While 27 percent of respondents said they are "knowledgeable" in selecting savings and investment options right now, only 15 percent said they are very confident they will be able to pick the appropriate options, and determine the right withdrawal amounts to make their savings last the rest of their lives, after they retire.

Not Just Guarantees but Good Returns

An economic analysis by Jeffrey R. Brown, assistant professor of finance at the University of Illinois, Urbana-Champaign, demonstrated that a lifetime annuity has the potential to provide a higher level of sustainable income than can be achieved with other financial assets, combined with guaranteed income for life.[12]

> "This is because a life annuity is an insurance product that pools resources across a large number of annuity buyers, essentially using the resources of those who die earlier than expected to pay higher benefits to those who live longer than expected. The 'cost' of this approach is that assets that are converted into a life annuity stream are no longer available to leave as a bequest. In exchange, however, the life annuity provides surviving individuals with a higher rate of return than the individual could get on an otherwise similar, but unannuitized, portfolio."[13]

Brown's research compared the rate of return for a $100,000 lifetime annuity purchased by a 65-year-old with the expected rates of return for three alternative strategies: self-annuitization, "amortization" and "one divided-by remaining life expectancy."

The lifetime annuity would provide $7,704 in annual income, based on the economic conditions at the time of the analysis. This income stream would continue as long as the retiree lives.

Compare this to the self-annuitization strategy, which Brown described as investing $100,000 in a market-rate instrument and withdrawing $7,704 per year in income. A retiree following this strategy would run out of money at age 85. Brown noted that some 30 percent of today's 65 year olds will live beyond age 85.

Under the "amortization" strategy, the retiree would invest the $100,000 at market interest rates and amortize the total amount over a 35-year period, age 65 to age 100. Amortization provides the retiree with nearly 25 percent lower income than annuitization. Moreover, the retiree's assets would run out at age 100.

Under the "one divided by remaining life expectancy strategy," a retiree would invest the $100,000 at market rates and then follow a draw-down strategy based on consuming a fraction of remaining wealth that is proportional to the individual's remaining life expectancy.

This is similar to one of the methods permitted by the Internal Revenue Service for meeting distribution requirements from qualified pension plans, Brown noted. This approach produces an income stream that never exceeds 94 percent of the annuity income level and falls to less than 40 percent before the retiree reaches age 95.

Personal finance writers and advisers often promote what is called "the four percent rule" for managing retirement savings.[14] Under this strategy, retirees withdraw four percent of their assets in their retirement portfolios in the first year. The next year, retirees withdraw the same amount adjusted for inflation, and so on for every year thereafter. This strategy is promoted as valid for a period of 25 years or more.

However, this strategy does not offer guarantees. Retirees following the four percent rule are still exposed to longevity risk, the risk of outliving their assets. Compared to a life annuity, initial payments under the four percent rule are substantially lower. For all of these alternative non-life annuity strategies, there is no 100 percent probability that payments will last for the life of the retiree.

"By allowing retirees to exchange a portion of their retirement nest eggs for a guaranteed lifelong stream of income, annuities have the ability to protect retirees from substantial declines in their standard of living at older ages. As such, economic theory suggests that life annuities ought to play an important role in the portfolios of retirees," Brown says.[15]

Employers Key to Helping Employees

Employers can play a central role in retirement security. Providing employees with lifetime annuity distribution options and better information about their retirement assets is a natural evolution of the role employers have long played in the financial landscape.

In a subsequent *BNA Insights*, ACLI will present its suggestions for federal regulatory and legislative changes that will reduce barriers to including lifetime annuities as distribution options in defined contribution plans and providing workers with information about their retirement savings in a more useful format.

The threshold question, however, is why employers should assume this role. The answer is that most employees already look to their employers for basic financial products such as group life insurance, disability insurance, long-term care insurance and annuities.[16]

This commitment by employers helps to increase employee awareness and understanding of the nature and benefit of these products. Whether employers pay for all or a part of these products, or permit employees to pay for them through payroll deduction, the availability of financial security products at the workplace encour-

[12] The New Retirement Challenge; Brown, Jeffrey R; Americans for Secure Retirement, September 2004.

[13] *Id. page 9.*

[14] See, e.g., *The ABCs of Investing: Safe Withdrawal Rate for Retirement Funds—4%, http://www.abcsofinvesting.net/safe-withdrawal-rate-for-retirement-funds-4-rule/.*

[15] Brown, *op.cit. page 14.*

[16] 7th Annual Study of Employee Benefit Trends, MetLife (2009).

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ages employees to take action to protect themselves and their families.

The financial protection that can be provided by lifetime annuities may be less understood than the benefits of life and disability insurance. One reason for this may be the prevalence in the past of defined benefit plans which provided lifetime income without the need for an employee to make a decision to obtain the benefit.

As more and more employers choose to offer defined contribution plans over defined benefit plans, employers can play a key role in helping employees understand the benefits of, and gain access to, the protection provided by guaranteed lifetime income.

Academics write of the "annuity puzzle," that is, why so few retirees annuitize defined contribution benefits when annuities provide much needed income protections. Educating employers and employees about the value of guaranteed lifetime income and reframing defined contribution plan savings as a source of guaranteed lifetime income will help solve the annuity puzzle and help retirees achieve true lifetime financial security.

Conclusion

The RFI comes at a crucial moment in American history. The coming "tsunami" of retirements threatens widespread economic hardship on members of the baby boom generation who have not fully prepared for the risk of outliving their assets.

Millions of retirees over the coming 10-to-20 years may become a burden on the next generation of taxpayers if they exhaust their assets and can no longer afford basic living and health expenses.

When workers receive statements from the administrators of their retirement accounts, they usually see the total amount of their savings, along with information about how market fluctuations have affected their portfolios. While this information is important, it is incomplete.

Workers need and want information that will help them understand how their lump sum savings will address their month-to-month bread-and-butter needs after they retire. Workers also need and want employer-provided distribution options to devote a portion of their retirement savings to lifetime income vehicles.

Policymakers must provide employers and employees with the tools needed to visualize the need for guaranteed lifetime income and to address it. The RFI is a major first step.