No Better Annuity Deal than Social Security:

How to Help Employers Help Workers to Use Defined Contribution Balances to Delay Claiming

Written Testimony of

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2018 ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFIT PLANS
LIFETIME INCOME SOLUTIONS AS A QUALIFIED DEFAULT INVESTMENT ALTERNATIVE (QDIA) –
FOCUS ON DECUMULATION AND ROLLOVERS

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9:00 am C5521 Room 4, U.S. Department of Labor

Thank you for inviting me to testify as you provide advice to the DOL for their guidance on how certain annuities could be a QDIA [ii].

6 Key Findings:

1. The issue of annuities in DC plans concerns about 20 percent of 28 million near retirees[iii] who are the most affluent and 25 percent of all retirement assets.
2. Experts conclude retirees need annuities to avoid anxiety and hardship; and people want secure lifetime income, but near retirees don't buy annuities creating a *market failure in annuity provision*;
   - Annuity markets fail because annuities are private insurance products which suffer from lack of pooling, adverse selection, and the profit requirement, all which makes annuities too costly:
3. Best annuities come from Social Security and the Bipartisan Policy Center Commission on Retirement Security and Personal Savings agrees;

4. Plan sponsors are unlikely to offer annuities because the cost and complexity likely can't meet ERISA reasonable protective standards;
5. Even if all sponsors offered annuities, the effect probably won't "move the needle" for the majority of the 28 million workers aged 55-64 because they don't have a DC or IRA plan or their assets are under $100,000;
6. Most older workers– about 28 million in 2018 -- would be helped more by delaying claiming Social Security than buying a commercial annuity and most plan sponsors – employers who have good intentions would appreciate guidance about how to help their employees.

Bottom Line: We need to do what we can to help employers offer advice for people to create their own temporary annuity that bridges the gap between retirement and claiming. The DOL should provide safe harbor education tools for employers.

Scope

About 27% of all retirement assets is practically annuitizable and the DOL wants to help make that share larger.

Of the $27 trillion in retirement assets (DB,DC, IRA) only 27% -- half of DB benefits -- are annuitized: $7.7 trillion in DC plans and $8.6 trillion in IRAs do not have practical ways to annuitized.

- Annuity products in DC plans would affect about 25% of retirement assets -- the $7.7 trillion in DC plans, not IRAs.
- Annuity products in DC plans would affect about 20% of the most affluent older workers.

28 million workers between 55-64 today are now wrestling with their retirement decisions. But, sadly, only twenty five percent or 7.3 million older workers today have assets over $100,000 and the average earnings are well over $90,000 per year.

I conclude launching creativity, effort, and time aimed at enabling people to delay Social Security benefit claiming – though leaving the early retirement age at 62 is important – would have a big payoff; almost all of the 28 million near retirees or their survivors would benefit from delay claiming Social Security benefits.[iv]

What Americans Can Annuitize Now from Retirement Assets

Type of Retirement Plan 2017:3 Investment Company Institute	Trillions $ (2017:3)
DB assets	8.9
DC assets	7.7
IRA	8.6
People aged 55-64 (37 million)	2.8
People aged 55-64 with DC and IRA plans with more than $100,000 in their accounts (19 million out of 37 million or 25%)	2.5

Economists Agree with People – Annuities are Important and Annuity Markets Fail*:*

Social Security provides annuities for most American workers, but the Social Security benefits are too low to cover most retirees' basic living expenses. Most retirees need more assets annuitized. Social Security increases lifetime indexed benefits for every month a worker delays collecting Social Security. For people born between 1956 – 1960 a $1125 monthly benefit claimed at 62 would be about $1980 for life collected at age 70, the system boosts benefits by about 7% per year between ages 62-70.

I quote from Webb's testimony: "To illustrate, a worker with a Full Retirement Age of 66 who delays from 66 to 67 earns an eight percent income return on his Social Security annuity purchase. In contrast, inflation indexed annuities currently offer income returns of under five percent at the same ages."

Here is yet another way to describe how much delaying Social Security is worth. Let's say someone went on the open market to by an annuity that increases 2% per year and starts paying $1125 a month at age 62. On the Fidelity calculator that stream of income would cost about $291,000 in 2018. If you bought a $1980 monthly annuity to be collected later, in 2026, at your age 70 that stream of income would cost -- $307,000. Waiting is usually cheaper, but the payment from Social Security is so much larger it pays to wait.

Economists puzzle over why people don't buy annuities even though people say they like annuities, especially if they think they will have a longish retirement [v] – a 2018 study shows that 73% of respondents consider guaranteed income as a highly-valuable addition to Social Security (up from 61% in 2017) and people are less likely to be depressed[vi] and anxious if they have an annuity (DB) rather than a lump sum to manage (DC). Social Security benefits, at the median, replace 36% of their preretirement income. People need about 60-80% of their preretirement income to maintain living standards so the other sources of annuities need to add to Social Security.

In short, people want simple annuities but don't buy annuities offered for sale. Given annuity product's complexity and dizzying array of [vii] details and fees – surrender charges, expense fees, death benefit fees etc.– and fundamentally the high prices that come from vendors having to price for adverse selection -- it is not a surprise that people don't buy annuities in the open market.[viii]

Market failures: People tell surveyors that longevity risk, the possibility they will outlive their savings, is a growing and significant threat to their retirement security and a source of deep personal worry. People want a solution to longevity uncertainty and the nation would be better off for solving it– accidental bequests would fall, hoarding would decrease, and fear and fear responses among the elderly – for instance skipping lunch and medication for fear of running out of money [ix] would also fall.

Annuities correlate with elderly well-being.

That the demand for annuities is not met by market supply constitutes a classic market failure that got worse when employer-based pensions morphed from annuity provision through DB to lump sums in DC plans and the DC cousin, IRAs (most IRA money is from 401(k) plans. I am afraid the DOL efforts to adopt regs aimed to tweak and nudge the voluntary, individual-directed, commercial-based DC system to be a good pension system– a good pension system is one that does what a three words acronym describes: "AID:" accumulate, invest, de-accumulate appropriately – probably won't be enough to "move the needle," or make a difference in the risk of inadequate retirement income.

Pension systems are only good at accumulating, investing, de-accumulating efficiently and effectively when contributions and annuities are mandatory and investment decisions are professional.

But I write now to help tweak the voluntary, individual – directed, for commercial system we have. The problem of IRA lumps is another key issue since most of the $8.6 trillion IRAs come from DC plans. I suggest concrete guidance on page 4. Next, I tell the Advisory Council how the 2016- 2017 Bipartisan Policy Center's Commission on Retirement Security and Personal Savings members wrestled with the issue of transforming lumps to annuities in DC plans and came to Social Security as the best source of annuities.

Social Security's Appeal and the Bipartisan Policy Center's Commission on Retirement Security and Personal Savings:

The Bipartisan Policy Center chaired by Senator Kent Conrad and the Honorable James Lockhart met in 2016 to develop solutions to the retirement crises. Among the 50 or so tweaks and recommendations constructed from spirited discussion and dismay about the failed annuity market were many similar to this one: "that plan sponsors integrate sophisticated but easy to-use lifetime-income features within retirement savings plans (see page 62 of the final report.)[x]

Below are some highlights of our discussion that might help the Advisory Council. The members of the BPC deliberated at length about the market failure – as you surely are doing – and eventually we became more attracted to the idea that the best place to buy an annuity is from Social Security[xi], and that allowing annuity products into 401(k) s and IRA will not likely solve a significant portion of the retirement crises and may cause even more problems and predation.

Commission members discussed at length the pitfalls and potentials of plan participants being able to purchase a guaranteed lifetime-income product. We recommended that plan sponsors use ideas from marketing and behavior finance – as Mark Iwry[xii] calls "Naming and Framing" would establish a default lifetime-income option and/or offered what is a called "an active-choice framework" in which participants are asked to choose options from a customized menu.

We were concerned about the pitfalls, and therefore were not excited about the potential. More specifically we were worried about the high fees and insecurity of the commercial annuity products and the low account balances that would make an annuity quite small.

At the very least we were concerned about the "junk" that might end up in the plans.

For the annuity product to be acceptable the fiduciary would need a separate fiduciary analysis of the annuity part of any default investment. Sadly, we are aware, most workers want a fixed annuity. But industry wants to sell variable annuities. Fees for variable are triple of fixed. And the insurer always wins – they have to, they have a duty to shareholders. An anonymous expert and practitioner told me "Market up, insurer gets a big cut. Market down, insurer cuts return to payee. Surrender charges if try to cancel."

So we had a blue-sky discussion. **And, we got excited about ways employers could help participants delay claiming Social Security benefits by choosing to schedule withdrawals from their retirement plan to facilitate later claiming of Social Security benefits.** A good product would annuitize for the length of time it would take for the participant to reach age 70.

Convincing someone to delay claiming is difficult. People like lump sums, they feel if they wait they have a higher chance of never collecting, and they need the money after they stop working. The average age of claiming is about 63. We all have stories of trying to convince friends and loved ones to delay. Here is one of mine:

> "Mike, don't collect at 62, use your $80,000 K plan for living expenses in the next two years then collect a higher Social Security."
>
> "No, I am keeping that, what if I need a liver transplant?"

The BPC recommended clearing barriers to offering a wider array of choices for lifetime income in both retirement savings and pension plans. In concept, participants aged 55 and older should be allowed to use their DC savings to purchase longevity annuities that begin payments later in life. Workers with defined benefit pensions should be able to receive part of their benefit as a lump sum and the rest as monthly income for life, rather than the all or-nothing choice.

We got really excited about employers having safe harbors to limit their legal risk as they offer features and education to change norms and what is viewed as sensible choices about money and Social Security, and "Mike" might have felt more comfortable spending down and delaying claiming if other people were doing it.

The Best Annuity is from Social Security

Social Security, to the greatest extent, and large defined benefit pension plans to a smaller extent all leverage the power and efficiency of mortality pooling to help individuals manage the risk of longevity. Life annuities from insurance companies also do but the insurers need to make a profit and protect against adverse selection. For employers to annuitize in a DC structure – it is key to the DB structure – the group bases are too small, the risk of adverse selection too high, and the incentives to secure lifelong retirement income for their employees is not a key corporate goal. Buying annuities from insurance companies (we aren't even dealing with who insures the insurers – undercapitalized state insurance funds mainly from New York and New Jersey) is just too expensive, especially compared to Social Security.

One of the best and easiest way to get a higher annuity is from Social Security. This is the plan. Buy or devise your own "temporary annuity" with your DC and IRA account in order to wait to claim Social Security at a later age. Every year you wait you will increase the size of your Social Security annuity by an average of 7.41% for every year you wait to claim between the ages of 62 and 70 (the retirement benefit boost one gets from delaying from 62 to normal retirement age, say 67, is lower than the delayed retirement credit from 67 to 70, which is the more familiar 8% per year delayed retirement credit people refer to). Since most individuals need a larger annuity to cover basic living expenses than what their Social Security collected at or below full retirement age will be, supplementing the annuity is attractive and I applaud DOL to try and help employers and employee pay out the 401(K) in an annuity. But balancing the need for choice and regulating the private products may produce unacceptable risk since the products are often not understood or advised by experts – search the internet for analysis of annuities and you get warnings from Kiplinger's, Forbes and Consumer Reports.

Will Annuities in DC Plans "Move the Needle?"

It's worth noting that the number of people this policy would affect could be quite small. There are 28 million workers aged 55-64 – "near retirees," a third have no retirement savings, so the median account balance of workers approaching retirement is just $15,000. Of the 65% of older workers -- age 55-64 – with retirement savings in defined contribution (DC) or IRA accounts or defined benefit (DB) pension coverage from a current or past job their median account balance is $92,000. (Low income workers have far lower coverage as one would expect, only 50% of low-income older workers (earning less than $40,000 annually) have any plan besides Social Security; 20% of middle class workers (earning between $40,000 and $115,000), and a large share -- perhaps a deficit that is more than expected -- 15% of high-income workers ($115,000 plus) have neither retirement savings or a DB pension.[xiii])

The median account balance of those with retirement savings is $92,000—annuitizing at 65 would bring about $7000 per year. [xiv]Among account holders in the top 10% of earners, the median balance is $250,000, annuitizing at 65 would yield $19,000 per year. The extra $7000 per year in an annuity for the median holder would replace 14% of pre-retirement income of workers with accounts, which is insufficient to maintain pre-retirement living standards. They would need at least enough to replace 25%.

Buying Social Security Annuities by Delay Claiming[xv]

If the median account holder could hang on and spend down the $92,000 and delay collecting Social Security from 62 to 70 instead of annuitizing that person would have $10,000 more per year from Social Security– starting at 70 -- and the annuity would be *indexed* for inflation. Of course they would have to work and economize in order to wait to collect the larger, super charged, Social Security benefit, but the advantages of the extra Social Security benefit are so large that they likely outweigh the cost of temporary cutbacks in spending while delaying claiming.

Another way to see that a senior should spend down the DC lump while waiting to claim Social Security benefits is to compare scenario 1 – collecting early Social Security and using your $100,000 to buy a $338 per month annuity (calculated from the Fidelity calculator[xvi]) at age 62. You would get $1463 ($338 --the annuity - + $1125 –the early Social Security) — for the rest of your life. Scenario 2 is to scrape and spend down the $100,000 for 8 years – they will be lean years living on $1041 per month instead of $1463 but pay off is that the delayed Social Security benefit will be far higher than $1463, it will be $1,993 per month at age 70.

You can see these examples can multiply and become more pertinent to an individual's situation.

- **Here is our offer. The New School team can help construct a model language, completing the job the BPC didn't have time to do.**

What Employer Sponsors May Find Helpful From the DOL

For an employer who cares about the retirement future of their employees – and my read of the literature and my own survey of plan sponsors[xvii] (over 100) convinces me that they do care and view 401(k) as inadequate since workers don't save enough and employer contributions may be lump summed out. Therefore their "heart" is not eager to contribute more – since they have to do a lot to ensure an annuity option meets ERISA standards designed sensibly, to protect workers.[xviii] DOL should PREPARE model language – perhaps this could be a job for the PBGC since it is the only agency in the federal government (29 U.S. Code § 1302 - Pension Benefit Guaranty Corporation) directly charged with helping out retirement security "to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants and to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries," though the context is, of course, DB plans. Tony Webb and I can help by constructing a language that might help employers educate their workers about how spending down a $150,000 lump to delay collecting Social Security for 2 years would benefit their financial future.

In sum: most employers would love to help their employees delay collecting Social Security and workers would get a boost. I conclude that the commercial annuity market just can't solve the lifetime income problem for most people even if the products were in the DC and IRA universe.

Endnotes and References

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[i] Thanks to Michael Papadopoulos for his research assistance on the numbers of older workers and how much IRA and 401(k) balances they have.

[ii] The 2018 Advisory Council on Employee Welfare And Pension Benefit Plans

scope for the hearing on June 19 is the following:

- Definition of Lifetime Income ('LTI') within a DC plan
- Rationale for including LTI features in a DC plan option
- Lifetime Income products and innovations in the DC market place or elsewhere
- Observations on the usage of Lifetime Income products in DC plans
- Analysis of QDIA Issues: o Current QDIA language and safe harbors

  o Definition of defaulted participants and notice requirements

  o Selection of annuity providers embedded in QDIA such as a Target Date Fund: who (e.g. plan sponsor, 3(38) managers) and how

- Assessment of Deterrents to incorporating LTI products in DC plans
- Review of Portability of LTI options including plan-to-plan rollovers
- Ideas to encourage participants' use of LTI products

[iii] Calculations from the CPS.

[iv] The DOL is wrestling with how to get people with appreciable assets, say $100,000 in their DC accounts to be able to annuitize. Of the 28 million workers who are nearing retirement aged 55-64 we estimate a small number 6.05 million have more than $100,000 in their accounts. Among

the bottom 50% only 41% of the 14 million older workers earning less than $40,000 per year have DC or IRA accounts and of those that do have the median balance is $32,000; 3.25 million of those in the middle 40% have more than $100,000, and we estimate all of the 2.8 million in the top 10% have accounts worth more than $100,000 because their median is over $220,000. See these two sources for the calculations: Ghilarducci, T., Papadopoulos, M., and Webb, A. (2017) "Inadequate Retirement Savings for Workers Nearing Retirement" Schwartz Center for Economic Policy Analysis and Department of Economics, The New School for Social Research, Policy Note Series and Ghilarducci, T.,

Papadopoulos, M. & Webb, A. (2018). "40% of

Older Workers and Their Spouses Will Experience

Downward Mobility in Retirement." Schwartz

Center for Economic Policy Analysis and

Department of Economics, The New School for

Social Research, Policy Note Series.

[v] Teppa, Federica, Can the Longevity Risk Alleviate the Annuitization Puzzle? Empirical Evidence from Dutch Data (July 1, 2011). De Nederlandsche Bank Working Paper No. 302. Available at SSRN: https://ssrn.com/abstract=1951891 or http://dx.doi.org/10.2139/ssrn.1951891

[vi] Two articles directly show that lifetime income adds to well being and lump sums are negatively related to well being. Panis, Constantine. 2004. "Annuities and Well Being." *In Pension Design and Structure: New Lessons from Behavioral Finance*. edited by Steven Utkas and Olivia Mitchell, Oxford: Oxford University Press. http://aacg.com/wp-content/uploads/2014/09/2004-Annuities-and-Retirement-Well-Being.pdf and Bender, Keith A. 2012. "An analysis of well-being in retirement: The role of pensions, health, and 'voluntariness' of retirement," *The Journal of Socio-Economics*, Volume 41, Issue 4, 2012, Pages 424-433,

[vii] http://time.com/money/4713497/guaranteed-retirement-income

[viii] Please see Anthony Webb's testimony for details.

[ix] Elderly, for fear of running out of money may skip lunch and medication for fear of running out of money. Most bequests are accidental suggesting hoarding. Hendricks, Lutz, Intended and Accidental Bequests in a Life-Cycle Economy (March 2002). Arizona State University Economics Working Paper No. 5/2002. Available at SSRN: https://ssrn.com/abstract=304721 or http://dx.doi.org/10.2139/ssrn.304721

[x] https://cdn.bipartisanpolicy.org/wp-content/uploads/2016/06/BPC-Retirement-Security-Report.pdf

[xi] Sass, Steven. 2012 Should You-Buy and Annuity From Social Security Center for Retirement Research, Boston College Policy Brief and Ghilarducci, T., Webb, A., & Papadopoulos, M. (2018). "Catch-Up Contributions: An Innovative Policy Proposal for Social Security." Schwartz Center for Economic Policy Analysis and Department of Economics, The New School for Social Research, Policy Note Series.

[xii] Temple-West, P. 2018. "Can Nudge Really Work ?" Politico June 6. On line: https://www.politico.com/agenda/story/2018/06/07/can-millennials-save-retirement-000665

[xiii] Ghilarducci, T., Papadopoulos, M., and Webb, A. (2017) "Inadequate Retirement Savings for Workers Nearing Retirement" Schwartz Center for Economic Policy Analysis and Department of Economics, The New School for Social Research, Policy Note Series. And for an international perspective on how poor American elderly are see: Disney, Richard F. and Whitehouse, Edward, The Economic Well-Being of Older People in International Perspective: A Critical Review (June 2002). Luxembourg Income Study Working Paper No. 306. Available at SSRN: https://ssrn.com/abstract=324883 or http://dx.doi.org/10.2139/ssrn.324883

[xiv] Some of these folks may be better off hanging on to some of their cash for use as an emergency fund. Small balances should be left alone. Australia is dealing with this puzzle in depth.

[xv] Other ideas about how to add to Social Security that is not pertinent to the ERISA Advisory Council purview on June 19: Webb, Ghilarducci, Papadopoulos proposed for an AARP innovation grant a catch-up contribution program for Social Security that illustrates the potential of adding annuities to Social Security. Every worker would be defaulted into higher Social Security contributions at age 50 and older. The additional Social Security contribution would be 3.1 percent of salary, a 50 percent increase on current employee contributions (employers would not change).

For a worker earning $40,000 per year they would contribute an additional $24 a week or a little under $19,000 over 15 years. If workers could add to Social Security they could help bridge the gap between their retirement income and amounts required to maintain pre-retirement living standards. Benefit calculation under Social Security would follow current law, but using the earnings record that included the catch-up credit. Monthly benefits would increase from $66 - $345 or 7 – 3% per month depending on lifetime income (highest earners get a larger dollar amount and smaller percentage increase. Ghilarducci, T., Webb, A., & Papadopoulos, M. (2018). "Catch-Up Contributions: An Innovative Policy Proposal for Social Security." Schwartz Center for Economic Policy Analysis and Department of Economics, The New School for Social Research, Policy Note Series.

[xvi] Fidelity has a helpful Guaranteed Income Estimator at this web address: https://gpi.fidelity.com/ftgw/interfaces/gie/

[xvii] Arias, Daniela and Ghilarducci, Teresa. (2011) "Pension Reform's Stake in Employers" Schwartz Center for Economic Policy Analysis and Department of Economics, The New School for Social Research, Working Paper Series

[xviii] In Louis Campagna's thorough letter to TIAACREF he lays out what employers would have to do. I paraphrase: important to evaluate the demographics of the plan; make a considered decision about how the characteristics of the investment alternative align with the needs of participants and beneficiaries taking into account, "among other things", liquidity restrictions, notices, education, guarantees, interest rates, fees and investment expenses, and their reasonableness. in relation to the benefits and administrative services to be provided. And, the closing comments "Whether the selection of any particular investment alternative, including the ILCP, as a default investment alternative satisfies the fiduciary duties of prudence and loyalty in

ERISA section 404(a) with respect to any particular plan would depend on the facts and circumstances." That statement would probably make ant sponsor back away.