Response to "Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans"
RIN 1210–AB33

by
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I write in response to the request for information regarding lifetime income options for participants and beneficiaries in defined contribution retirement plans. As background, I have spent most of the past 15 years focused on research, policy and practice in the area of retirement income security. I have published a wide range of articles – including academic research papers as well as policy briefs – on annuities and other lifetime income products. In addition to my faculty position at the University of Illinois, I serve as associate director of the NBER Retirement Research Center. I have also worked on issues related to retirement income security through a range of policy roles, including serving as a senior economist at the White House Council of Economic Advisers (2001-2002), as a staff member for the President's Commission to Strengthen Social Security (2001), and as a Presidential appointee to the bipartisan Social Security Advisory Board (2006-2008). Because of my expertise in this area, I have been a consultant and/or speaker for a large number of insurance companies and other providers of retirement income products. I also serve as a trustee for TIAA, the largest private provider of annuity income in the United States. While these various roles have exposed me to the issue of retirement income security from a variety of perspectives, I should stress that the comments I am providing in this response are mine alone, and do not necessarily reflect the views of any of the institutions or organizations with which I currently have, or have had in the past, an affiliation or relationship.

I applaud the Departments of Labor and Treasury for requesting information on this important issue. As I have written extensively elsewhere, the U.S. retirement system's reliance on 401(k) plans and other defined contribution (DC) plans has provided a reasonably effective means of accumulating assets for retirement. However, the current system is woefully inadequate when it comes to providing participants with secure retirement *income*. The near-exclusive focus on asset accumulation pervades the entire retirement system, whether it is the disparity between the large number of investment choices that the typical plan offers in the accumulation stage versus the very limited payout options available in the same plan, or whether it is the manner in which we communicate with employees (in terms of account balances rather than in terms of sustainable monthly income). In order to change the retirement landscape to one in which plan participants have adequate opportunities to convert their wealth into guaranteed retirement income, a concerted effort is required to re-align public policy, plan design, and participant behavior.

In total, your request for information raised 39 distinct questions. I will not attempt to answer them all here. I will, however, refer you to existing research papers that relate to many of these questions. I am also offering to make myself available to discuss any/all of these questions with the relevant staff at Treasury and Labor, as well as any other interested parties within the U.S. government.

Question 1: To briefly summarize the voluminous literature on the value of annuitization, life annuity products are the single most efficient (i.e., least cost) way of providing a guaranteed level of retirement income (due to the "mortality premium" that they can provide, and annuities are a valuable form of insurance against outliving one's resources. The primary disadvantages of traditional annuity products are that one gives up the right to wealth upon death (this is the source of the mortality premium), and that standard annuity products impose liquidity constraints upon individuals because it is difficult to borrow against future annuity income streams.

For more discussion on these issues, see Jeffrey R. Brown. "Understanding the Role of Annuities in Retirement Planning." NBER WP 13537 www.**nber**.org/papers/w13537

Most of the academic literature in this area suggests that the right balance of these issues involves a high (but not 100%) level of annuitization. Indeed, because there are some risks best addressed by annuitization (e.g., longevity risk), and other risks best addressed by having liquid wealth (e.g., uninsurable shocks to one's expenditure needs), the optimal allocation of the typical DC plan should involve *partial* annuitization (i.e., neither zero nor full). For more discussion of the theoretical aspects of this issue, see: Tom Davidoff, Jeffrey R. Brown, and Peter A. Diamond. "Annuities and Individual Welfare," *The American Economic Review*, Vol 95, No. 5,

Question 2: I have written extensively on these topics and I would encourage you to read one or more of my reviews of the literature for a fuller explanation of what the literature has to say on these topics – see, for example:

Jeffrey R. Brown. "Understanding the Role of Annuities in Retirement Planning." NBER Working paper 13537. www.**nber**.org/papers/w13537

Jeffrey R. Brown. "Financial Education and Annuities." Policy brief written for the OECD. www.oecd.org/dataoecd/38/0/44509379.pdf

To briefly summarize this extensive literature, there are three basic facts worth considering. First, there are a variety of "rational" reasons that individuals may not wish to annuitize all of their retirement wealth, including factors such as bequest motives, standard pricing loads (arising from adverse selection or administrative costs), lack of inflation protection, illiquidity, and more. Second, even after accounting for these factors, most (although not all) economic and financial models still suggest that people, on average, are annuitizing *less* than is optimal. Third, an emerging literature in behavioral economics provides compelling evidence that the observed lack of demand for annuities is *not* fully rational and indeed may be sensitive to plan design and the manner in which products are "framed." For example, in research that I conducted with several co-authors, we found that simply using "consumption" oriented language instead of the more commonly used "investment" oriented language can result in approximately a 50 percentage point difference in the fraction of the population that believes annuities compare favorably to other financial products.

For more information, see: Jeffrey R. Brown, Jeffrey Kling, Sendhil Mullainathan and Marian Wrobel. "Why Don't People Insure Late Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle." *American Economic Review*, 98(2): 304-309. May 2008.

Questions 3 – 10: The key fact worth noting here is that only a small fraction of 401(k) plans offer guaranteed lifetime income options inside the plan. While it is true that individuals have access to a broad range of annuity products in the retail space if they wish to access them through IRA rollovers, it should not be surprising that individuals fail to do so. I discuss this more completely in this paper:

Jeffrey R. Brown. 2009. "Automatic Lifetime Income as a Path to Retirement Income Security." Policy paper written for the American Council of Life Insurers. http://www.acli.com/NR/rdonlyres/E403B3C1-C827-44E5-8491-B3C31491C3B6/21227/Automatic_Lifetime_IncomePaper.pdf

In this same paper, I provide a lengthy discussion of why it is important the plan sponsor have a role to play in this process.

I believe it is very important to clarify the concept of "cost" in question 7. For example, it is certainly true that providing inflation-indexed benefits or survivor benefits requires that an individual pay more for the same initial dollar value of monthly benefits. However, to refer to these products as more "costly" would be a mistake because it fails to consider several factors. First, economists often use the concept of a "money's worth ratio" to evaluate pricing loads because this concept considers the expected lifetime benefits relative to the expected lifetime premiums paid. Second, even the "money's worth" concept is incomplete because it fails to consider the risk-reducing value (i.e., the insurance value) of the product.

Questions 11-14: I have an entire policy paper that explains why an "automatic annuity" is a worthwhile policy idea. This paper also discusses how such a plan might be designed. It also recommends that 50% of account balances be subject to this automatic annuitization requirement and explains the rationale for this choice. This paper can be found at: http://www.acli.com/NR/rdonlyres/E403B3C1-C827-44E5-8491-B3C31491C3B6/21227/Automatic_Lifetime_IncomePaper.pdf

Question 15: There are theoretical advantages to combining annuities with other investment and insurance products. In general, it is my view that *any legislation or regulation in this area should be sufficiently flexible so as to encourage continued* *innovation by the private sector.* There has been tremendous innovation in this product space just in the past 5 years, and there is every reason to suspect that innovation will continue so long as it is not discouraged by policy.

Question 16: Any policy in this area should carefully consider the effect of annuitization on surviving spouses. I believe it is imperative that any "default annuity" be one that provides survivor benefits when the plan participant is married. For example, if 50% of the account is subject to an annuitization default, then a "joint and 100% survivor" rule might be appropriate. I discuss this issue more in this paper:

Jeffrey R. Brown. 2009. "Automatic Lifetime Income as a Path to Retirement Income Security." Policy paper written for the American Council of Life Insurers. http://www.acli.com/NR/rdonlyres/E403B3C1-C827-44E5-8491-B3C31491C3B6/21227/Automatic_Lifetime_IncomePaper.pdf

Questions 17 – 20: As with any financial product, consumers need to be provided with adequate disclosures to make an informed decision. Given the potentially "irreversible" nature of some annuity contracts, it is particularly important in this context. Indeed, some thought might be given (as I discuss in the previously cited paper) of providing a temporary period of reversibility if individuals are to be defaulted into annuity contracts.

When disclosing information, however, I believe it is imperative that regulators not think of annuity products as being "just another investment product." It can be difficult – indeed, it may even be counterproductive – to illustrate "fees" in terms of "basis points," given that payout differences can arise from a large number of sources, some of which are true "fees" and some of which simply reflect the economic value of the product (e.g., the insurance against mortality risk, for example). In general, I believe that consumers will be better served if disclosures are stated in terms of "monthly income differences" or some other metric.

Questions 21 – 24: Elsewhere, I have supported the idea that quarterly benefit statements be expressed in terms of monthly income rather than solely as account balances (see, for example, the previously cited paper). Such an approach is a natural extension of the academic work on "framing" that suggests that individuals are more likely to understand the value of annuities when they are discussed in a context that emphasizes needs rather than a context in which individuals think of annuities as "investment" products.

Question 28: The required minimum distribution rules should be modified so that when an individual chooses to partially annuitize their DC account balance, they participant receives "credit" for the annual value of the annuitized distributions in every subsequent period. Indeed, I would strongly suggest that if a default annuity program were to be adopted that applied to 50% of the account balance, consideration be given to reducing, or even waiving, the required minimum distribution on the remaining account balance. After all, if the logic for *not* requiring annuitization of the full account balance is that there is value to participants in having access to a liquid, lump-sum of wealth (e.g., for uninsured health expenditures), then this logic would be inconsistent with then requiring the individual to spend down this lump-sum too quickly.

Questions 29 – 32: Because I am not a legal expert, I will defer to others on the specifics relating to fiduciary matters. However, I do wish to make two comments on the goals of these efforts.

First, plan sponsors should not be penalized for trying to do the right thing. We currently operate in a "backwards" environment in which plan sponsors who offer an annuity to their participants are subject to more fiduciary risk than plan sponsors who choose to leave their employees "on their own" by lump-summing them out of the plan. The policy goal should be to ensure that employers are not discouraged from offering annuities due to the actual or perceived fiduciary risk that employers take on if they choose to offer these products.

Second, I understand the importance of ensuring that plan sponsors choose a reasonably safe annuity provider, especially if participants are to be defaulted into an annuity. However, it strikes me as unnecessarily burdensome on plan sponsors (especially small plan sponsors) to require that each individual plan sponsor undertake a full review of the long-term claims paying ability of an annuity provider. This would also be socially inefficient in the sense that it would require tens of thousands of plan sponsors to duplicate one another's efforts in an attempt to choose a qualified provider. A desirable outcome would seem to be one in which plan sponsors are able to rely on credible third-party assessments of the long-term claims paying ability of an annuity provider.

Questions 33 – 35: A good case can be made that the ideal retirement system would be one that is focused on the generation of secure, lifetime income during one's retirement years. The provision of secure lifetime income should not be treated as a "post-retirement" issue: rather, it should be an integral part of plan design from the day that a new participant enrolls in a plan. As such, it is vitally important that plan sponsors have the flexibility to integrate the provision of annuities and other guaranteed income products into the "accumulation phase" of a plan. There are many ways to do this, including the use of annuity contracts during the accumulation phase (a practice which is common in the 403(b) space, the integration of deferred annuity products in the menu of portfolio options, the gradual conversion of non-annuitized assets into annuitized assets over the participant's lifecycle, and more. For example, one might imagine a life-cycle fund that invests in a mix of both fixed and variable deferred annuity units in addition to fixed and variable non-annuitized assets.

Such products have the potential to add enormous value to plan participants. As such, it is vital that any public policy in this area be sufficiently flexible so as to encourage innovative solutions.

Summary:
My brief responses above barely "scratch the surface" on these topics. I would again reiterate my willingness to discuss these any or all of these issues in more detail with any interested party within the U.S. executive or legislative branch. I can be reached at 217-333-3322 or by email at brownjr@illinois.edu.

Thank you for the opportunity to share my thoughts on this important subject.

Sincerely,

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