

Spotlight

Making State Retirement Plans Work for Private Employers: Including Lifetime Income Options

Melissa Kahn
Consultant

Jody Strakosch
Strakosch Retirement Strategies, LLC

Introduction

Federal and state policy makers are grappling with three major retirement security issues: (1) increasing access to retirement savings and pension plans; (2) improving savings adequacy; and (3) ensuring that accumulated savings last throughout an individual's retirement years. The first two issues have received much attention recently, with a growing number of states enacting legislation that would either require conducting a feasibility study¹ or implementing a state-sponsored retirement savings program for private-sector employers who do not currently sponsor a retirement plan for their employees.

The third issue, which focuses on ensuring that whatever savings are accumulated will last throughout an employee's lifetime, is only now beginning to receive attention at the federal level. It has not yet received much attention at the state level. We believe that while 401(k) plans are enormously popular, they have not yet been proven successful if we measure success by their ability to provide retirement income that lasts as long as the individual lives. Therefore, designers of state-sponsored retirement savings programs that target the three critical issues of access, adequacy, and lifetime income security should address how their program could ensure that individuals do not outlive their savings. These programs could incorporate lifetime income options into those savings programs.

A state-sponsored retirement savings plan could help millions of private-sector workers who are not covered by an employer plan build financial security. Several features will help a plan become more effective and produce more secure retirement. This report discusses how those plans can offer guaranteed lifetime income products that can help to ensure that employees' savings provide a stream of income that lasts for the rest of their lives.

Providing Lifetime Income Distribution Options

Employees will be faced with the challenge of how best to manage their accumulated assets to ensure that their savings last throughout their retirement years. Arguably, the most efficient financial product available today for ensuring a continuous lifetime income stream is a guaranteed lifetime income annuity. In designing state-sponsored programs, policy makers should seriously consider providing some form of lifetime income distribution option. Following are three options that state-sponsored plans could offer on a voluntary basis.



**Public Policy
Institute**

For more information on this article, please visit www.aarp.org/ppi.

1. **Immediate annuity at retirement.** Participants could use a portion of their assets to create a guaranteed lifetime income stream by purchasing an annuity that begins income payments within the first 12 months after buying the annuity. States could offer this option through an individual provider that agrees to offer such plans at a low price, an approach used by the federal Thrift Savings Plan. Alternatively, states could use an independent annuity shopping platform that features multiple annuity providers, which would enable savers to make an apples-to-apples comparison between different annuities. One of the advantages of offering an immediate annuity is that participants would not need to make a distribution decision until they are at the point of retirement—or even later. At that point, they would know their exact circumstances (for example, marital status, financial situation, health, physical location). The major disadvantage of such an approach for participants is having to make a “point in time” decision when interest rates may be low, which may result in a lower annuity payment compared to those available in a higher interest rate environment. Also, some individuals resist making a big financial decision that results in their losing control over a portion of their money, and that may limit the use of immediate annuities.
2. **Longevity annuity at retirement.** Longevity insurance is a deferred fixed-income annuity purchased at retirement or earlier that begins to make payments at a much later date, typically at age 80 or 85. The primary advantage of this type of annuity is that it requires a smaller sum to purchase than the immediate annuity, allowing the individual to retain the rest of their accumulated savings, and thus may be more appealing than the immediate annuity. Until annuity payments begin, retirees would live on Social Security and the rest of their retirement assets. Knowing that the longevity annuity payments will begin at a specified later age would allow individuals to know how long their savings must last rather than face an indefinite future, which increases their current spending power and provides greater peace of mind. The chief disadvantage of this approach for participants is that they would be giving up assets that would not be recouped if they die before the annuity payments begin.²
3. **A target date fund (TDF) that includes the gradual purchase of an annuity during an individual’s working lifetime.** Over the past few years, some providers have incorporated a form of guaranteed lifetime income payments into their TDFs. Starting when the saver reaches a certain age, a portion of the TDF is annually converted into an annuity so that by retirement, a preset proportion of the total is available as guaranteed lifetime income. The advantage of this product is that participants accumulate the income option as part of their ongoing investment in a professionally managed plan, rather than buying it at retail. Further, because the annuity is purchased over time, this method spreads the interest rate risk over a number of years, thereby protecting the saver from receiving lower payments if interest rates at retirement are low. One chief disadvantage of this approach is that there are record-keeping and other administrative issues that have not yet been fully resolved in the event the plan sponsor terminates the provider of the TDF with the embedded annuity. Portability may also be an issue if employees change jobs and want to roll their savings into the new employer’s plan.

Automating Lifetime Income Distribution Options

Even in plans that offer a lifetime income option, very few employees choose that option for a number of reasons, including loss of control, bequest motives, thinking of annuities as investments rather than insurance, and concern regarding the financial stability of the insurer. Only an estimated 16 percent of corporate-sponsored plans offer employees the option to purchase a lifetime income annuity from the plan,³ but when offered such an option, most employees choose the lump sum option (86 percent) and only 7 percent of participants elect to convert their assets into a guaranteed income stream.⁴ Further, as behavioral economics has shown, individuals may not take a course of action that is in their best economic interest. Therefore, states should

consider including an automatic lifetime income component in retirement plans they sponsor in which the employee is automatically enrolled unless he or she opts out.

The concept of automating a lifetime income payment follows the established precepts for automatic enrollment and automatic escalation that have met with success in the corporate-sponsored 401(k) market. Individuals are happy to have a portion of their wages automatically deducted from their paycheck and invested in a retirement savings vehicle. And, slightly less than 10 percent of participants elect to opt out of automatic enrollment and only 7 percent opt out of automatic escalation programs.⁵ Many public policy makers support this approach for the decumulation phase too.

States can design automatic income programs in a number of ways, all of which would still allow the employee to choose to take a lump sum at retirement rather than receive spaced payouts.

1. The *employer match* (if available) could be contributed to the lifetime income feature, either during the employee's working career or at retirement.
2. A *certain percentage* of the employee's contribution (for example, 10 percent) could be automatically allocated to the lifetime income option starting either at some point during the employee's working career or at retirement. As with the voluntary approach described earlier, this option could be structured either as an immediate annuity or as a longevity annuity.
3. *At retirement*, a certain percentage of the account balance could be used to purchase a trial annuity;⁶ this trial allows the participant to experience the benefits of a guaranteed monthly income payment for a prespecified period of time—say, 24 months—but then offers the individual the opportunity to “cash out” at the end of the trial period.

Issues for States to Consider

1. **Portability.** If states adopt a TDF structure with an annuity program, they will need to consider the portability of the lifetime income option when employees change jobs. States

should consider developing or participating in a record-keeping system that tracks the annuity for the individual during his or her working career. Alternatively, states could contract with a private database system that, through a unique identifier (for example, Social Security number), allows the employee to keep all accumulated lifetime income vehicles in one location. Furthermore, a fund that simulates the prepurchase of the lifetime income over time (“slices of an annuity”) could be developed so that the actual purchase occurs at a later time.

2. **Care and transparency in selecting products.** Whether or not individual state-sponsored plans are subject to the Employee Retirement Income Security Act (ERISA)—the law that regulates and monitors corporate-sponsored plans—states should follow a prudent, transparent process to document their decisions in choosing lifetime income programs. As part of the due diligence process, states should consider the price of the option, the services provided, and the financial capability of the provider. Establishing a committee that continues to monitor the options on a periodic basis would also be a prudent action.
3. **Selection of the annuity and provider, and distribution questions.** When offering an annuity, states must consider how to offer the annuity to individuals. For example, would the employer or the state select the insurer or the independent platform? Would ERISA fiduciary rules apply to that decision? Would the participant or the employer select the insured product? States should decide whether to offer a single lifetime income provider or to provide multiple providers through a shopping service (that is, a platform as described above). As discussed previously, decisions regarding the provider selection should be transparent and based on clearly stated criteria including price, services provided, and financial capability. Once the provider has been selected, the lifetime income product could be distributed in a number of ways, including voluntary selection by the participant at the point of retirement or through some form of automatic provision, such as a target date fund or trial annuitization.

Conclusion

States either enacting or studying the implementation of a retirement savings program for employers who do not currently offer their employees a retirement plan should consider in its design not only the accumulation of assets but their eventual use as retirement income. Otherwise, retirees may spend their nest egg too quickly and outlive their assets, or spend too slowly and inhibit their lifestyle. Furthermore, academic research is beginning to demonstrate that it is harder to make complex financial decisions as one ages.⁷

Although the issues surrounding inclusion of lifetime income options are complex, the fact remains that without their inclusion, state plans will not succeed in their ultimate goal: to ensure that individuals have sufficient retirement income to last throughout their lives. Because many retirement decisions are complicated and people don't necessarily have all of the information they need, states should consider automating decisions about how to save, how to invest, and, ultimately, how to manage that money in retirement.

- 1 California, Connecticut, Maryland, Minnesota, and Oregon included feasibility studies either in the bills that their state legislatures enacted or by executive order.
- 2 A death benefit could be offered as part of the annuity, but that would significantly lower future payments.
- 3 Aon Hewitt, "2011 Trends and Experience in Defined Contribution Plans" (Chicago: Aon Hewitt, 2011).
- 4 The remainder used a managed account with an income drawdown feature.
- 5 Building Futures, Plan and Participant Data Analysis, Powered by Fidelity Thought Leadership. https://communications.fidelity.com/wi/2013/buildingfutures/?utm_medium=referral&utm_source=consultant-web&utm_campaign=BuildingFutures.
- 6 W. G. Gale, J. M. Iwry, D. C. John, and L. Walker, "Increasing Annuitization in 401(k) Plans with Automatic Trial Income" (The Retirement Security Project, 2008).
- 7 S. Agarwal, J. C. Driscoll, X. Gabaix, and D. Laibson, "What Is the Age of Reason?" Center for Retirement Research at Boston College. July 2010, No 10-12. http://scholar.harvard.edu/files/laibson/files/ageofreason_supplement.pdf.

Spotlight 334, JANUARY 2016

© AARP PUBLIC POLICY INSTITUTE
601 E Street, NW
Washington DC 20049

Follow us on Twitter @AARPolicy
On facebook.com/AARPolicy
www.aarp.org/ppi

For more reports from the Public Policy
Institute, visit <http://www.aarp.org/ppi/>.



Real Possibilities

**Public Policy
Institute**