

BNA Insights

Policy Approaches to Addressing Longevity Risk for Retirement Income Security



By FRANK TODISCO

American private sector workers today face a new and growing challenge in planning for and managing their retirement—significant longevity risk.

Over the past quarter century, defined contribution plans have displaced traditional defined benefit plans as the most common plan type in the private sector. This change not only has left workers bearing responsibilities to manage individual retirement accounts, both in the accumulation and decumulation phases, but also has left them bearing numerous and significant risks.

One particular concern is longevity risk, which can be stated simply as the risk of outliving one's assets. The shift in pension coverage from defined benefit to defined contribution means that for more and more U.S. private sector workers, Social Security will be their only source of income that is guaranteed to last for as long as they live. Since Social Security is only intended to provide a floor benefit, these workers are now exposed to significant longevity risk.

Access and usage are two reasons why vast numbers of workers are now exposed to longevity risk. Access means limitations on the availability to workers of guaranteed lifetime income options. Usage means decisions by retiring workers not to utilize such options when they are available.

Most defined contribution plans do not offer a lifetime income option. Defined benefit plans are required to offer a lifetime income option, but many of them now also offer benefits as a lump sum—and when such a

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choice is available, retiring workers usually take the lump sum.

One additional complicating factor is the growing pool of IRA rollover money, which also is available as lump sums. Another complicating factor is that most retirees are not familiar with available lifetime income options, never having purchased income annuities (as distinct from the more popular investment annuities) in the retail market.

In February of this year, the U.S. Departments of Labor and the Treasury (DOL and DOT) issued a joint Request for Information (RFI)¹ regarding lifetime income options in retirement plans—indicating the intent of the executive branch to give serious attention to longevity risk and related retirement security issues (20 PBD, 2/2/10).

Along with hundreds of other organizations and individuals, the American Academy of Actuaries' (the Academy) pension and life practice councils submitted comments by the departments' May deadline (85 PBD, 5/5/10; 37 BPR 1083, 5/11/10).² And in June, the U.S. Senate Special Committee on Aging held a hearing to address these same issues (115 PBD, 6/17/10; 37 BPR 1405, 6/22/10).

The RFI, while not constituting a proposal of any kind, does fit into a broader pattern of retirement income security policy activities. With defined contribution plans now providing the majority of private sector coverage, policy efforts—at both the legislative and regulatory levels—have focused on making these plans work better for workers and retirees.

Legislation and proposals in recent years have addressed such topics as auto-coverage, auto-enrollment, auto-escalation, target date funds, investment advice, and fee disclosure. Now comes this joint effort by DOL and DOT to look at lifetime income.

For defined benefit plans, however, recent policy efforts mostly have been about funding relief—an attempt, whether one favors it or not, to “stop the bleeding,” rather than to overhaul and revive the defined benefit model. While a more comprehensive review of defined benefit plans would be desirable, given the compelling advantages and efficiencies of such plans in providing retirement security, that would be a topic for a different type of article.

Given the current reality of society's reliance on defined contribution plans and the concomitant risks, policy efforts to improve upon defined contribution outcomes should be commended and supported. Those efforts are validated by the risk management and effi-

¹ Available on the DOL Website at <http://www.dol.gov/federalregister/PdfDisplay.aspx?DocId=23512>.

² Available at http://actuary.org/pdf/pension/aaa_rfi_050410.pdf.

ciency advantages of guaranteed lifetime income, discussed in the next section.

Advantages of Guaranteed Lifetime Income

A guaranteed lifetime income protects a retiree against both the longevity risk of outliving assets and the investment risk of market losses. In addition, receiving a fixed amount monthly—rather than holding a large lump sum—serves to aid budgeting: it reduces the risk of overspending.

With a lump sum, a retiree could suffer from “wealth illusion” and not realize how quickly the funds could be diminished. Further, money management can become a much more daunting task at very advanced ages, due in no small part to susceptibility to fraud.

In addition to these important risk advantages, a guaranteed lifetime income is also much more cost effective and economically efficient for a retiree than is a lump sum. It is far more economically efficient for an individual to address longevity risk through a risk pooling mechanism than by “self-insuring.”

With risk pooling tools, such as life annuities, the underlying cost to the individual of the guaranteed lifetime income is based, roughly, on the life expectancy of the covered group. For a 65-year-old, for example, the cost might equate to the equivalent of having funds that can last to about age 85; the collective savings from cessation of paying out to those who die sooner sustains those who live longer.

In contrast, in order to self-insure by way of a lump sum, an average individual would need funds sufficient to cover the plausible possibility of living to a very ripe old age—and living into the late 90's or even to age 100 are no longer miniscule “risks.” Self-insuring against this possibility becomes very expensive. On top of the extra funds needed for this longevity risk, the self-insuring retiree may need an additional cushion to mitigate against market setbacks.

Looked at another way, given a fixed lump sum, a self-insured retiree would have to endure an unnecessarily low standard of living to make sure the lump sum lasts until a very advanced age. Risk pooling allows a materially higher level of consumption and a better lifestyle—an economic benefit to both the retiree and society.

Converting a lump sum into guaranteed lifetime income is not the right answer in all situations or for all individuals. Two such examples are high-wealth individuals and situations in which there is a bequest motive.

In some cases, a partial conversion of the lump sum may be optimal. From the standpoint of economic utility theory—which posits that not every dollar of income is of equal importance to an individual—guaranteed lifetime income has high value for participants, employers, and society—up to a point. For taking care of basic physical needs and reasonable social needs, the value of a guarantee is high.

At some point beyond those basics, the value of guaranteed income drops significantly and the value of a bequest to heirs increases correspondingly. A logical policy question then is: “How much guaranteed income should public policy facilitate, encourage, or incent?”

To the extent that guaranteed income is of high value, the cost efficiency of risk pooling validates the ef-

fort to try to facilitate such arrangements. The next section discusses how to do so.

Greater Access and Use of Lifetime Options

Efforts to enhance access to and use of lifetime income options must be multifaceted and address at least three areas: education and behavior; alternative forms of guaranteed lifetime income; and requirements and accommodations.

Education and Behavior. “Financial literacy” has become a hot topic in retirement policy circles. Greater understanding of the importance of saving, investment risks and rewards, money management, and retirement income needs is properly seen as essential to enhancing the effectiveness of relying on defined contribution plans for a significant portion of retirement security.

Consumers also should understand the central concept of longevity risk and will need guidance on when and how to address it. And for situations in which individuals are making decisions outside of a sponsored plan, such as with a rollover IRA, they would benefit from some understanding of what is a fair price for an annuity, how to shop for one, and the extent of state regulation or government guarantees.

Financial education can be obtained from multiple sources, starting even in primary or secondary school. It also should be encouraged and facilitated in the workplace.

Standardized communication requirements and model disclosures and educational materials could provide uniform information, simplify administration, reduce fiduciary risk for plan sponsors, and enhance participant understanding. When feasible, providing personalized, quantified communication with each annual benefit statement can be helpful.

But while education is fundamentally important, it can go only so far. Policy changes also need to be informed by the lessons of behavioral finance. Consumer decision-making is determined by both rational analysis and human psychology. The efficacy of education is based on the former, while behavioral finance strategies are based on the latter.

Behavioral finance strategies consist of two types: (1) reframing language and presentation, and (2) restructuring choices and defaults. Research has shown that the choice of words, the order and context of presentation, the number of choices, and the default selections can have profound effects on outcomes, without limiting freedom of choice in any way.

These design elements can be used to overcome human tendencies to procrastinate, get distracted, be drawn to big numbers, misjudge risk, or simply become overwhelmed.

One might describe financial education approaches as “changing people to fit programs.” Since the predominant private sector retirement security program is now defined contribution, people need a higher level of financial literacy for these programs to work effectively.

In contrast, one might describe behavioral finance approaches as “changing programs to fit people.” Defined contribution programs need to be intelligently designed—in terms of choices, defaults, and framing—to reflect the irrational aspects of human decision-making.

Utilization of both approaches—educational and behavioral—is essential to success.

Forms of Guaranteed Lifetime Income That Could Increase Usage. One size does not fit all. Use of lifetime income options can be enhanced when a reasonable degree of variation is available to individuals or plan sponsors. Using annuitization terminology, these variations include partial annuitization, refund annuities, and deeply deferred annuities.

Individuals may be reluctant to convert their entire account balance into lifetime income—and in many cases a partial conversion is all that would be necessary to address basic needs and longevity risk. A partial annuitization option provides more flexibility, taking into account each individual's unique situation and retirement income needs.

Other individuals are reluctant to convert to lifetime income because of a fear of dying early and "losing" the money paid for the annuity. The "loss" is not real from an insurance perspective—in the same way that one's fire insurance premiums have not been "lost" just because one's house doesn't burn down.

So, too, money converted into longevity insurance is not wasted just because the longevity doesn't occur. But the perception of loss is real. In some cases, concern for such a loss actually indicates that there is an underlying bequest motive that shouldn't be annuitized in the first place—provided retirement income needs can otherwise be met.

Regardless, refund-type annuity options, such as cash refund annuities or life annuities with a guaranteed "certain" period, could lead to significantly higher annuity election rates, even though these annuities are slightly more expensive and thus provide somewhat less longevity protection.

Deeply deferred annuities are income annuities that are typically purchased by individuals who are near retirement and that guarantee an income that begins many years later, commonly at age 80 or 85. These deferred income annuities often are referred to in the marketplace as "longevity insurance." In reality, however, all types of guaranteed lifetime income provide some degree of longevity insurance, i.e., protection against longevity risk.

Deeply deferred annuities can be an attractive option because they can be purchased at a fraction of the cost of annuities that start immediately. They are suitable for those who can meet shorter-term needs through savings and other exhaustible resources. But they cannot be used in tax-qualified retirement plans unless the required minimum distribution (RMD) rules are modified.

Requirements and Accommodations. In many areas of policy, a key question is the extent to which desired policy outcomes should be required, as opposed to encouraged. There is often, of course, a fertile middle ground, such as requiring that a particular option be in place. The requirement gives a big assist to the broader societal goal and policy objective, while the option keeps the ultimate choice voluntary.

In its response to the RFI, the Academy made one such policy recommendation: require that some form of guaranteed lifetime income be one of the investment or distribution options offered in individual account plans. Tax-qualified programs that are intended to help encourage retirement security should offer the most reliable form of retirement security—a guaranteed lifetime income.

The Academy, however, stressed that it is essential that a set of comprehensive, manageable regulations be in place concurrently with the start of any such requirement so that plan sponsors (both large and small) can fulfill this requirement without exposure to excessive fiduciary risk. Absent workable regulations and fiduciary support, employers would be discouraged from sponsoring these plans and participants would fail to benefit from their potential.

Individual plan sponsors also should be permitted to make an annuity the default option, but should not be required to make this the default option, in light of the complexities involved in evaluating each individual's situation.

Finally, in any policy approach to facilitating the availability of lifetime income options, accommodations may be needed for small plans. For example, any mandatory participant education requirements could prove overly burdensome for small plan sponsors, leading them to choose not to sponsor retirement plans. A standardized set of minimum educational material could address this concern.

Conclusion

Continuing increases in life expectancy and an aging population have dramatically increased the scope and magnitude of longevity risk. The decline of the traditional pension and the growing dominance of individual account plans, along with policies being proposed to encourage even more of the latter, have diminished the capacity to mitigate that risk.

Exploring policy solutions that could address these concerns about retirement income security is the right thing to do. The best time to plan for the anticipated future risk is indeed now.