EXECUTIVE OFFICE OF THE PRESIDENT

COUNCIL OF ECONOMIC ADVISERS

Supporting Retirement for American Families

February 2, 2012

The Retirement Landscape

A wide range of risks can threaten a secure and stable retirement for American retirees. Inflation can drive down the purchasing power of retirees' accumulated assets. Low rates of return and high administrative fees on financial assets can reduce the flow of income that can be derived from retiree wealth. Unpredictable life events—such as a medical emergency or an unexpected need for long-term care—can quickly deplete retirement savings. Lastly, and perhaps most importantly, extended longevity can pose a risk to retirees who did not anticipate living so long and find themselves with insufficient assets. As a result of these and related factors, the Center for Retirement Research at Boston College has estimated that the share of households at risk of not having sufficient assets for retirement at age 65 has increased from 31 percent in 1983 to 51 percent in 2009 (Munnell, Webb, and Golub-Sass 2009).

Social Security traditionally has helped to mitigate many of these risks by offering retirees a stable, predictable income stream for retirement. Social Security benefits are adjusted for inflation, so that their purchasing power does not fall over time. Distributions are determined by a formula based on lifetime earnings and age of retirement, so that they are not subject to risk associated with financial market fluctuations. Lastly, Social Security payments are guaranteed to continue for retirees' entire remaining lifetime, regardless of how long they live.

On average, Social Security benefits can be expected to provide only about 55 percent of lifetime average earnings (Mitchell and Phillips 2006). Consequently, most retirees require additional income from other sources to adequately meet their needs. In the past, those retirees receiving employer-sponsored retirement saving benefits typically did so through a traditional defined-benefit (DB) pension, which supplements Social Security income by offering a steady stream of income for life. While payments from traditional DB plans typically are not adjusted for inflation, these plans do protect workers from other forms of risk such as market risk and longevity risk.

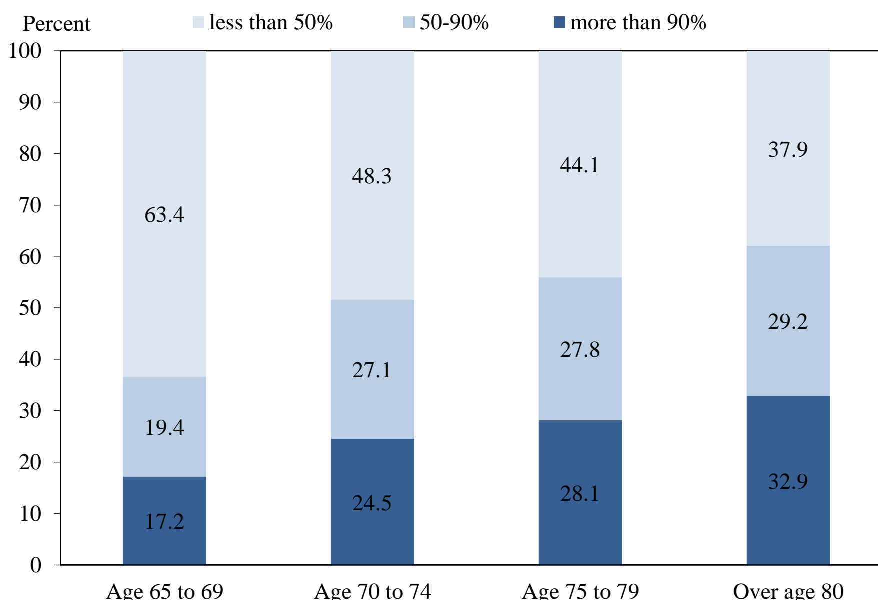
Traditional DB plans have become less prevalent over time, especially in the private sector, and gradually have been replaced by both 401(k)-type defined-contribution (DC) plans—plans under which employees accumulate assets that they can draw upon in retirement—and hybrid DB plans, such as cash balance plans, that resemble DC plans in practice. The share of private-sector workers covered by DB pension plans fell from 38 percent in 1980 to 20 percent in

2008. As a result of the continued decline in DB participation relative to DC plans, the share of retirement plan assets in DB plans has also fallen. In 1980, 71 percent of private employer-sponsored retirement plan assets were held in DB plans (including cash balance plans), but by 2009, 60 percent of these assets were held in DC plans. While 401(k)-type plans offer workers some important advantages—such as portability, high potential for growth, and flexibility—the shift to 401(k)-type plans also has transferred substantial risk from employers to workers.

The aggregate shift from traditional DB plans to 401(k)-type plans and hybrid DB plans highlights the problem of diminished prevalence of lifetime income benefits. This trend is exacerbated by lump-sum payouts from defined-benefit plans. One study found that, among those offered the choice in a traditional DB plan, 73 percent elected to take a lump sum (Mottola and Utkus 2007). The combined effect of increased 401(k) popularity and more frequent lump-sum distributions is that workers increasingly are exposed to market, inflation, and, in particular, longevity risk that threatens their retirement security when lump-sum assets have become exhausted.

The shift away from guaranteed lifetime income can be expected to increase the importance of Social Security in later years as long-living retirees outlive their assets. It is suggestive that, in 2010, the share of elderly Americans receiving most of their income—90 percent or more—from Social Security was just 17 percent for 65 to 69 year olds, but nearly double that percentage for those aged 80 and over (see Figure 1). Six out of ten elderly Americans aged 80 and above relied on Social Security for at least half of their family income.

Figure 1: Percent of Individuals with Various Shares of Family Income from Social Security, by Age of Householder, 2010



Source*:* Current Population Survey, Annual Social and Economic Supplement.

Workers seeking to bolster their lifetime income through the private market have limited access to private annuities. Annuities can be purchased either through an employer-sponsored plan or directly by an individual. Access to annuities through employer-sponsored plans is fading. One estimate shows that the percentage of DC plans offering an annuity option at retirement fell from 31 percent in 1999 to 17 percent in 2003 (Brown 2000), and only about 2 percent of plans offer workers the chance to gradually purchase annuity units along with stock and bond selections.

The shift in the retirement saving landscape away from lifetime income products has raised particular concern over longevity risk—the risk that retired workers will outlive their assets. The continued movement away from traditional DB plans towards 401(k) and hybrid DB plans means that fewer people can count on a guaranteed stream of pension income in retirement. Given declining but uncertain mortality, retirees are faced with the difficult task of choosing how much of their DC plan assets and other savings to spend in any given year. Retirees who live longer than expected may find themselves without sufficient assets at the point in their life when they are most vulnerable. This risk is particularly salient for women, who have longer expected lifespans than men and therefore are more susceptible to longevity risk.

There are a number of different approaches to shoring up retirement security for Americans. One is to encourage Americans to save more for retirement. This is the goal of

efforts by the Administration and many in the private sector to encourage expanded participation through automatic enrollment and related automatic features in 401(k) plans, and the President's automatic IRA proposal to expand coverage by extending the benefits of automatic enrollment in workplace payroll-based saving to tens of millions of workers without access to employer plans. A second approach is to ensure that plan sponsors are provided adequate information to minimize administrative fees and maximize returns on plan assets. The new fee disclosure rules announced today will serve as a valuable tool for plan sponsors in this endeavor. Another approach is to ensure that Americans have a better choice of retirement products and plan-provided options that can help them manage the risks they will face in retirement. Several of the initiatives announced today aim to remove barriers that have prevented annuity providers and plans from offering the full array of such options, bringing valuable choice to retirement savers.

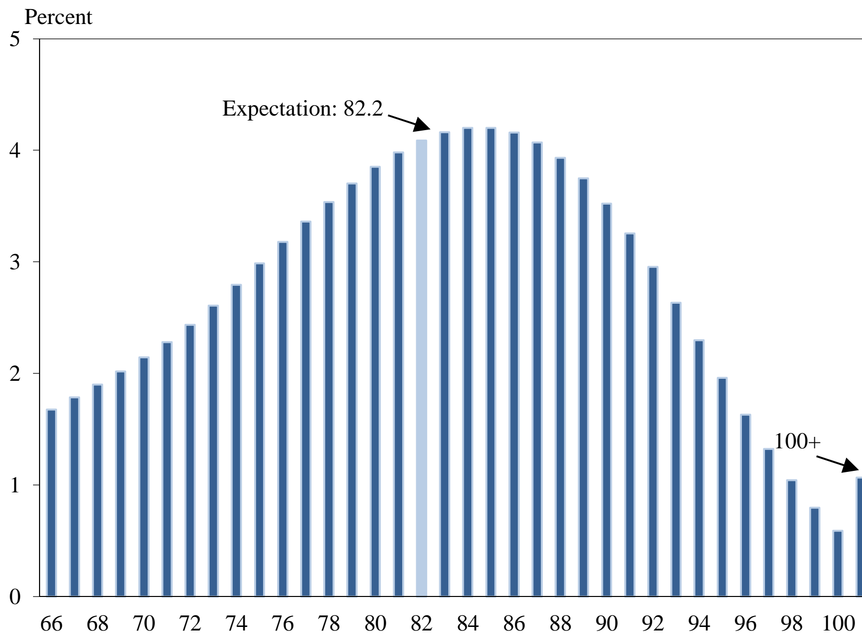
Benefits of Annuitization

Annuitization is the term for using liquid retirement wealth to buy a schedule of future income payments. Each year, a small proportion of retirees elect to use a portion of their liquid retirement assets to guarantee a stream of income for life. This stream of income can begin either at the date of retirement (immediate annuities) or, less often, at some future date (deferred annuities). Deferred annuities are typically annuities that are purchased during the working years and begin paying at retirement; the payment can be made either as a lump sum or, less often, as a stream of income. This type of annuity typically is utilized due to the tax-advantages of such an arrangement and in practice is more like a 401(k) than a standard annuity. Less common are longevity annuities, a special class of deferred annuities that are purchased at retirement and begin paying later in life; such products are designed specifically to provide income support for those with extended lifespans.[1] Most types of annuities may be structured to provide death benefits for surviving spouses and other heirs, inflation protection against the risk of rising prices, and various other features.

[1] One report found that in 2004, sales of deferred annuities dominated sales of immediate annuities, with deferred annuity sales amounting to $209.2 billion compared to just $5.6 billion for immediate annuities (Ranade 2006). Discussions with industry experts indicate that the vast majority of the deferred annuity sales were of conventional products rather than longevity annuities.

Annuities can help to mitigate some of the risk faced by retirees. In particular, annuities protect retirees against the risk of outliving assets. This risk is substantial. In 2007, the average 65 year-old male could expect to live an additional 17.2 years, but many will live much longer; nearly a fifth of 65 year-old men could expect to live to at least age 90. As already noted, at older ages, a significant share of individuals have essentially exhausted their other assets and are almost entirely dependent upon their Social Security benefits. For those individuals with the good fortune to live long lives, annuities augment the longevity insurance provided by Social Security benefits.

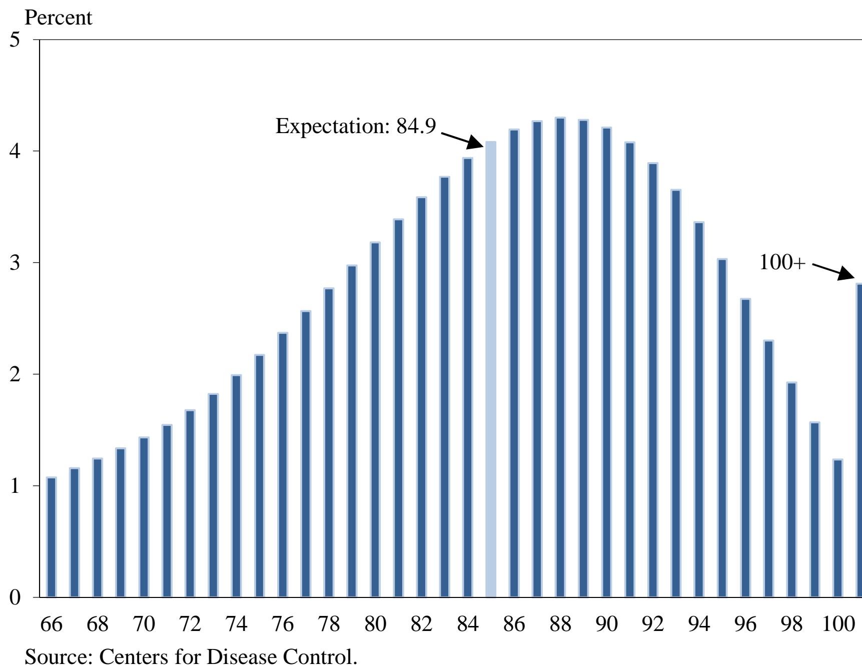
Figure 2: Lifespans for Men Aged 65 in 2007



Access to annuities is a particularly salient issue for women. Even though women's participation rate in retirement plans is equal to that of men, women tend to have significantly lower overall retirement income and retirement assets than men, due in part to lower wages and lower rates of full-time employment among women during their working lives. If anything, these facts understate the need for improved retirement security among elderly women, since women have longer life expectancies, and more uncertainty about lifespans, than men. The average American female turning age 65 in 2007 could expect to live 19.9 additional years—2.7 more years than the average American male. In addition, women are much more likely to reach

advanced ages. Among 65 year-old women in 2007, 30.7 percent will live to at least age 90, much higher than the share of 65 year-old men who are expected to reach age 90. Moreover, average lifespans have been increasing. Between 1970 and 2007, the average life expectancy for a 65-year-old female increased from 82.1 years to 84.9 years, while the average life expectancy for a 65-year-old male rose from 78.1 years to 82.2 years. And elderly women are more likely to live in poverty than elderly men. In 2008, 17 percent of unmarried women age 60 and over were poor, and an additional 20 percent were nearly poor, with incomes between 100 and 150 percent of the official poverty level. The disparity for women becomes particularly pronounced at older ages: at age 75 and above, 12 percent of (married and unmarried) women lived below the poverty level in 2010, compared with only seven percent of men. All of these factors create additional urgency for women to ensure a secure stream of income throughout retirement.

Figure 3: Lifespans for Women Aged 65 in 2007



Source: Centers for Disease Control.

The current market for longevity annuities is very small. There has, however, been growing interest in this product. Because longevity annuities typically are purchased at or near retirement but do not begin paying benefits until considerably later, they can be offered at a fraction of the cost of annuities that pay immediate benefits. For example, an annuity for a 65 year-old that offered a guaranteed stream of payments of $20,000 per year beginning

immediately might cost $277,500, while a deferred annuity offering the same annual benefits starting at age 85 might cost just $35,200. The primary benefit to a longevity annuity is that it offers retirees protection against the risks of extended longevity at an affordable price, while also allowing them to retain most of their wealth for other purposes.

Recent studies by economists have found that, from a theoretical perspective, longevity annuities should lead to large gains in expected well-being for retirees. For example, one study found that retirees who used a portion of their retirement wealth to purchase a longevity annuity commencing at age 85 could be made about 10 percent better off relative to retirees who did not purchase an annuity at all (Gong and Webb 2010). This gain in well-being is accomplished by preventing outcomes in which retirees end up with very low incomes at older ages.

Longevity annuities should be particularly attractive to older women due to the demographic factors described above (although the longer expected lifespan for females will be incorporated in the price of the annuity). Since women have a higher chance of living to older ages, an annuity product specifically focused on providing longevity protection may be of notable interest to women. Unfortunately, private providers of lifetime annuities and, in particular, longevity annuities face several regulatory barriers to offering these products. Today's announcement aims to implement reforms that remove many of these barriers.

Removing Barriers to Annuitization

Despite the potential that lifetime income products have to mitigate risk, very few retirees elect to purchase either immediate or longevity annuities. Economists refer to this disconnect as the "Annuity Puzzle." A variety of explanations have been offered. Individuals may avoid annuities because of concerns over the irrevocability of the choice to purchase an annuity; the desire to retain liquid assets in case of unexpected medical costs or as a bequest to heirs; concerns over the complexity of annuities, their lack of transparency, or the long-term financial soundness of annuity providers; a lack of understanding of longevity risk and how lifetime income products can help manage it; or a lack of familiarity with annuity products, among other factors. Individuals may also be dissuaded from purchasing annuities due to their price. Like other financial arrangements that protect from risk, the present value of annuity payments can be

expected, on average, to be somewhat lower than the annuity's price.[2] Part of this difference is due to adverse selection—the increased likelihood that healthier individuals purchase annuities. As more individuals enter the annuity market, the adverse selection problem can be expected to decline and the price of annuities may fall.

Several factors (beginning with limited demand from employees and plan sponsors) have constrained the purchase of annuities, including certain regulatory barriers and plan sponsor concerns about violating fiduciary responsibility by selecting an annuity provider with limited long-term financial stability. The proposed actions taken by Treasury today will help remove some of those constraints by easing and simplifying regulations that have limited lifetime income options. In particular, these administrative steps will facilitate the ability of DB plans, 401(k) and other DC plans, and IRAs to offer participants the choice of using only a portion of their entitlement to purchase an annuity, taking the rest as a lump sum. This will allow workers to avoid the behavioral obstacle of an "all or nothing" annuity choice architecture.

Relaxing the Application of Required Minimum Distribution (RMD) Rules to Accommodate Longevity Annuities in DC plans and IRAs. RMD rules require that a portion of traditional IRA and employer-sponsored plan assets be distributed over the life or life expectancy of a plan participant after the participant reaches age 70 ½. These rules were put in place to ensure that retirement plans are used to provide retirement security rather than avoid estate taxes on bequests to heirs. However, the regulations applying the RMD rules have had the practical effect of impeding the offering of longevity annuities in plans and traditional IRAs. One of the improvements offered today will exempt longevity annuities (up to a specified limit) from RMD rules to enhance the ability of 401(k) plans and IRAs to offer individuals the option to use an "affordable" portion of their account balance to purchase a longevity annuity.

Simplifying Regulatory Requirements to Facilitate Partial Annuities in DB Plans. Another improvement issued today by Treasury would simplify the procedure for calculating the amount of a partial annuity offered by a DB plan. This would ease the regulatory burden on plan

[2] The ratio of the expected value of annuity benefits to the premium is called the "money's worth." Several studies have found the money's worth to be approximately 0.85–0.90, with a slightly lower money's worth for inflation-protected annuities (Brown, Mitchell, and Poterba 2002; Gong and Webb 2010).

administrators and encourage DB plan sponsors to allow workers to divide their benefits between an annuity and a lump-sum cash payment.

Establish a Road Map for Self-Annuitization from DB Plans. The administrative package issued today would provide regulatory guidance encouraging employers that sponsor both DC and DB plans to offer DC plan participants the option of using their DC payouts to purchase an annuity from the employer's DB plan.

Clarify 401(k) Spousal Benefit Rules for Deferred Annuities. The administrative guidance also would encourage 401(k) and other DC plans to provide annuities by clarifying how regulations relating to spousal death benefits apply to deferred annuities (including longevity annuities) offered by those plans.

The Role of Investment and Recordkeeping Fees

Retirement plan sponsors often are not provided adequate information on the investment and recordkeeping fees charged to their plans. As compensation arrangements are growing increasingly complex, the need for better disclosure has become even more apparent. Inadequate reporting can make it difficult for plan sponsors and fiduciaries to assess the full cost of administering a plan. In addition, plan sponsors and fiduciaries may not understand the compensation incentives of plan servicers, which can potentially bias the advice provided to plan sponsors. In short, plan sponsors and fiduciaries often lack the information necessary to act in the best interest of the plan.

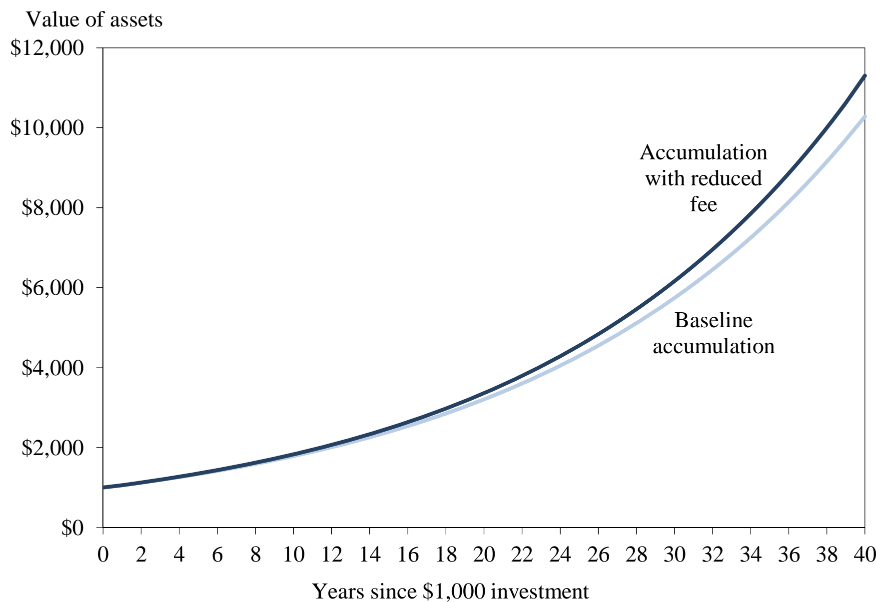
Of equal importance is the lack of transparency for plan participants. Plan sponsors, faced with complex and opaque fee arrangements, are unable to convey information about fees to plan participants. Plan participants, in turn, cannot demand cost-efficient products in which to invest their hard-earned retirement plan contributions.

The lack of transparency in plan fees contrasts sharply with some other financial products. For example, investors in mutual funds and other investment vehicles are typically provided information on fees paid in the form of an expense ratio, which expresses the fees paid

as a proportion of fund investments.[3] Investors may also pay investment fees on either the purchase or sale of the financial product, denoted as front-end loads or back-end loads respectively.

Improved fee disclosure may lead to lower fees if plan sponsors can better assess the value and worth of the services provided. Moreover, if plan participants have access to better information on administrative and investment fees, they may be able to demand more efficient and cost-effective products and services. In addition, to the extent that compensation arrangements may disproportionately reward plan servicers for providing particular products, improved disclosure may lead to an improved portfolio allocation and higher return on plan assets. All of these factors could lead to higher accumulated capital at retirement, as small differences in annual rates of return can lead to large gains in cumulative returns over time. For example, a 0.25 percent higher return after fees could increase the cumulative savings of a 25 year-old worker by about 10 percent by retirement (see Figure 4).

Figure 4: Simulated change in cumulative assets with a 0.25 percent higher return after fees



Note: Baseline calculation assumes a 6 percent rate of return.

[3] Most, but not all, fees associated with mutual funds are included in the expense ratio.

Today's final announcement issued by the Department of Labor will require certain plan service providers to provide DB and DC plan fiduciaries with information they need to evaluate service provider compensation. This information includes the direct and indirect compensation received by the service provider, its affiliates, and/or subcontractors; the sources for indirect compensation and services to which such compensation relates; and details on recordkeeping and investment-related fees. By making information more transparent, this rule will reduce the time and cost for fiduciaries to obtain compensation information needed to fulfill their fiduciary duties, discourage harmful conflicts of interest, improve decision-making by fiduciaries about plan services, enhance value for plan participants, and increase the Department of Labor's ability to redress abuses committed by service providers.

There is evidence that these improvements have already begun to impact the fee structure for workplace retirement plans. A recent *Wall Street Journal* article noted that plan sponsors were preparing for today's announced rule change by "tinkering with investment fund lineups, switching to lower-cost index funds, coupling cheaper funds with tailored advice, adding call-center staff to field questions from account holders, and creating simple templates for disclosure statements." The article also noted that "the prospect of increased scrutiny on fees is prompting employers to change their investment lineups to offer more low-fee funds," citing a six-fold increase in the proportion of funds adjusting their investment lineups (Greene and Tergesen 2012).

Benefits of Today's Guidance

The Administration aims to facilitate the provision of a better menu of lifetime income products to workers in the private market (including employer plans). While economic studies have established the benefits of annuitization for retirees—including both immediate and longevity annuities—many workers have only limited access to these products. The administrative guidance issued by the Treasury today, easing and simplifying certain regulatory requirements for retirement plans and IRAs, takes an important first step towards a more complete private market offering more attractive lifetime income options.

Exempting longevity annuities from RMD rules will make it possible to allow plan participants to use accumulated funds in 401(k) and other DC plans and in traditional IRAs —

valued in 2010 at almost $9 trillion—to purchase longevity annuities. Facilitating partial annuitization from DB plans as well, and encouraging employers that sponsor both DC and DB plans to allow DC plan participants to use their payouts to purchase an annuity from the DB plan effectively accomplish the same goal: helping participants to select an appropriate level of annuitization given their particular preferences and needs in retirement. Clarifying how the plan qualification rules apply to deferred annuities in 401(k) and other DC plans will also make it easier for the plans to offer annuities.

A primary goal of this initiative is to take a small but crucial step towards a retirement saving landscape that allows retirees to select the type and amount of protection against risk that is right for their circumstances. Some individuals may want to annuitize all or most of their accumulated assets. Others may elect to forgo annuitization outside of Social Security. Ultimately, improved access to a more user-friendly, serviceable, and complete range of lifetime income options can be expected to result in a more secure retirement for millions of Americans.

In addition, today's guidance will improve the salience of the information available to retirement plan fiduciaries. These fiduciaries have been expected to serve the best interests of their plans with incomplete information on plan costs and the nature of the compensation received by plan servicers. As these arrangements increase in complexity, the need to provide better disclosure has become evident. Today's ruling will better support plan sponsors in their mission to provide workers with a retirement plan that will best enable them to accumulate wealth towards retirement.

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