



Improving Defined Contribution Payouts: The Role of Annuities

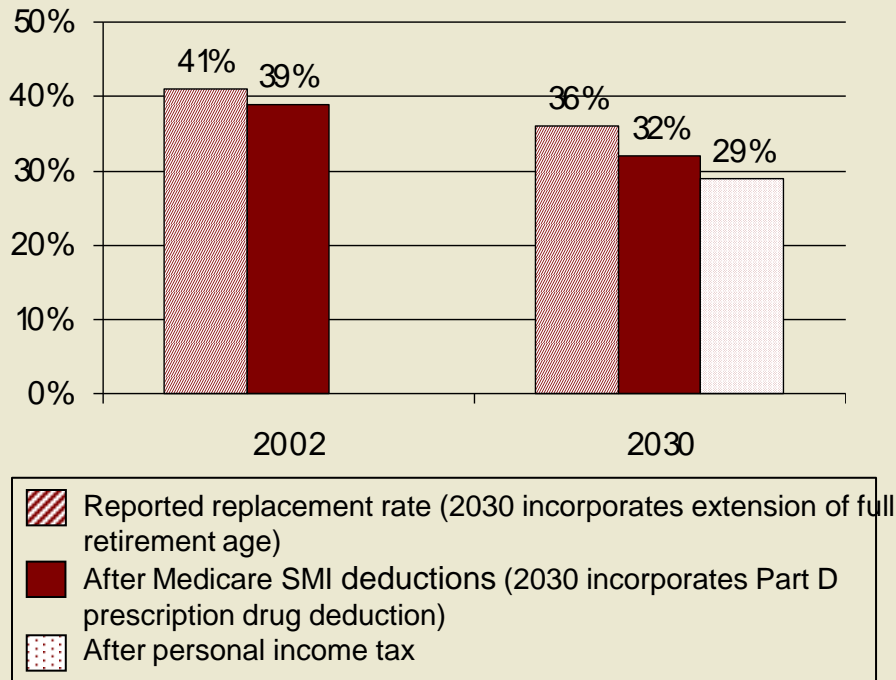
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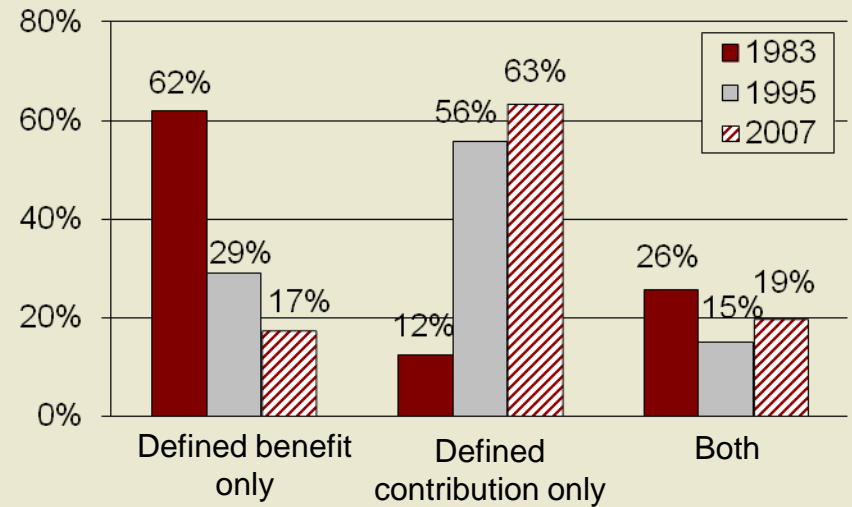
Designing Adequate DC Pensions
Policy Recommendations for DC Pension Design
Annual OECD/IOPS Global Forum on Private Pensions
Sydney, Australia
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The shift away from defined benefit plans is particularly striking in the United States.

Social Security Replacement Rates for Average Earner Retiring at Age 65, 2002 and 2030



Workers with Pension Coverage by Type of Plan, 1983, 1995, and 2007



Sources: Author's updates based on Alicia H. Munnell. 2003. "The Declining Role of Social Security"; and Alicia H. Munnell, Francesca Golub-Sass, and Dan Muldoon. 2009. "An Update on 401(k) Plans: Insights From the 2007 SCF."

The shift to DC and lump-sum payouts has created two risks:

Running out of money

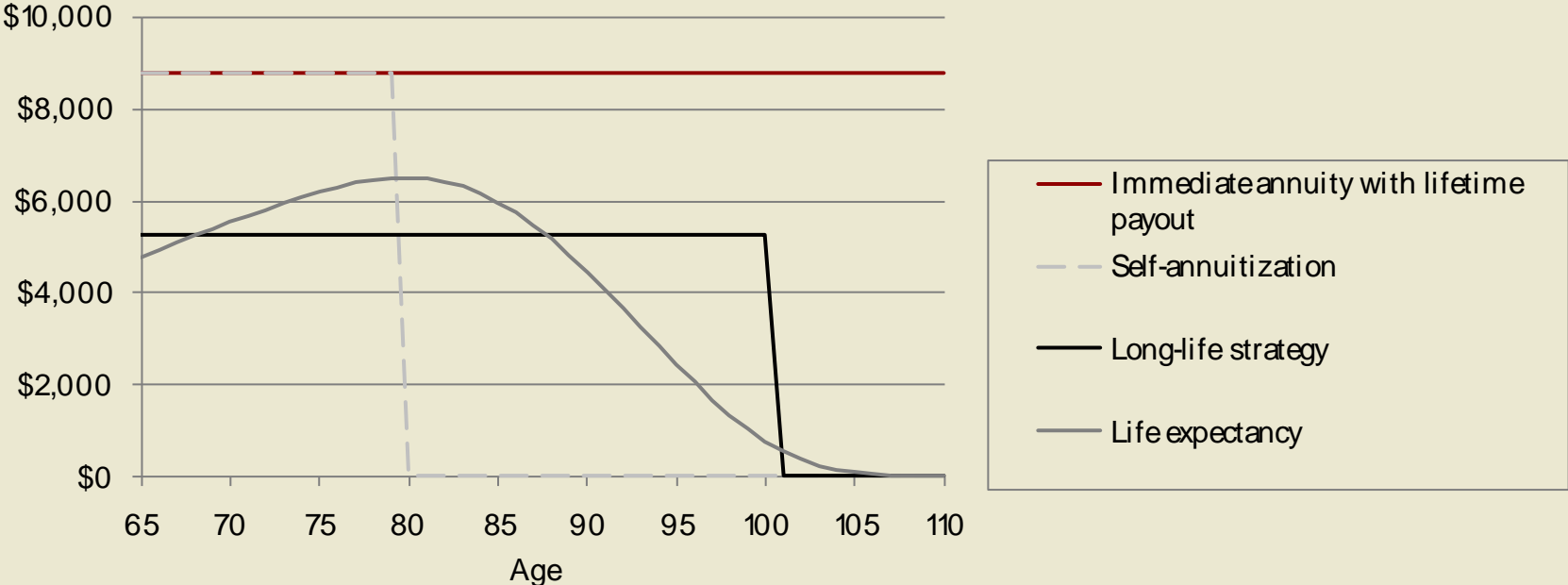


Consuming too little



Annuities could solve the problem.

Income Produced from \$100,000 by Annuitization Versus Alternative Asset Management Strategies

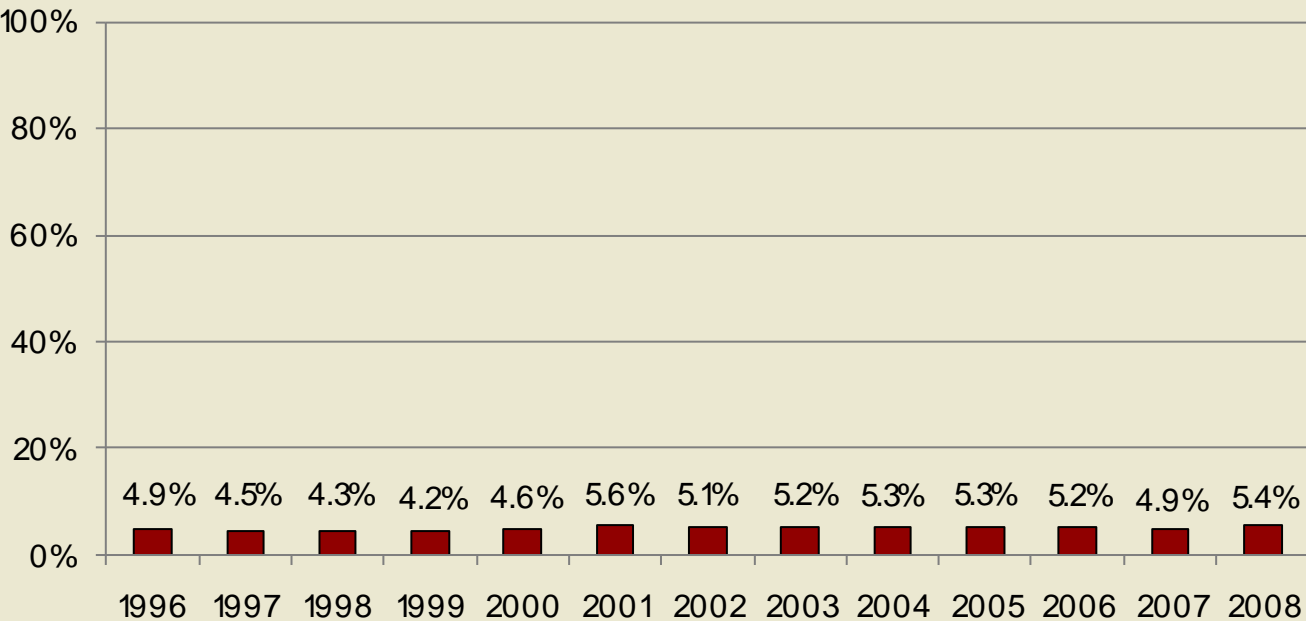


Note: Assumed rate of return on investments is 4.25%. Mortality is based on the Internal Revenue Service Single Life Expectancy Table (unisex).

Source: American Council of Life Insurers. 2005. "Managing Money for Life: How Annuitization Works." Washington, DC.

But people don't purchase annuities voluntarily.

Immediate Annuity Premiums as Percent of Total Annuity Premiums



Source: LIMRA International. 2002. *The 2001 Individual Annuity Market: Sales and Assets*. Windsor, CT; and updates from LIMRA International.

Researchers have suggested many reasons why people don't buy annuities.

- Rational response
- Ignorance of risks and product benefits
- Behavioral biases

The solution depends on the reason.

If the decision not to buy an annuity is a rational response to:

- a bequest motive;
- substantial prior pre-annuitized wealth;
- the risk of large out-of-pocket health care costs;
- intra-family risk sharing; and/or
- costly products,

Then *no action is needed*.

If the problem is ignorance, then education is the answer.

- Educate people about variance around their household's life expectancy;
- Communicate the advantages of annuities;
- Help people translate piles to flows by providing flow information during accumulation phase.
- Facilitate comparisons of annuities with different features.

If the problem is behavioral, then framing is important.

ISSUES

Framing effect



Fear of losing control of assets



Fixation on the present over the future (hyperbolic discounting)



SOLUTIONS

Consumption vs. investment frame.

Re-position as way to gain control over income and spending.

Use tools to create vivid view of "future self."

But in the end, defaults or mandates may be needed.

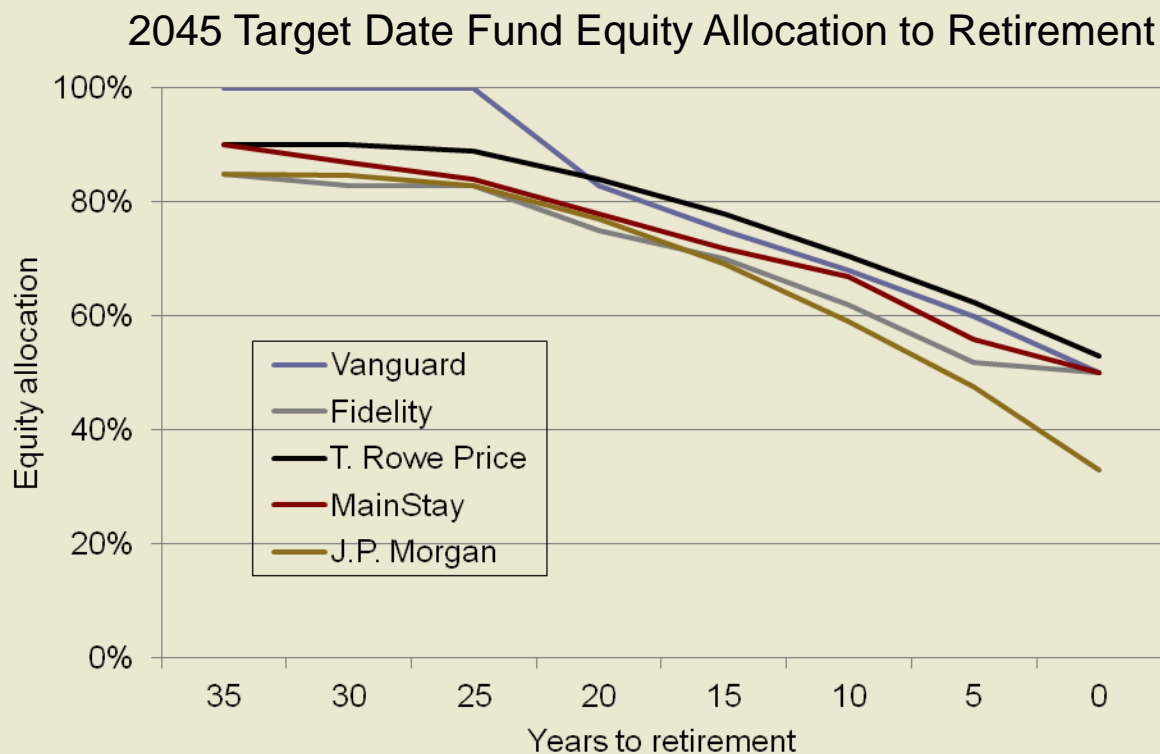
- Include annuities in accumulation phase.
- Establish defaults to annuitize some portion of accumulation through:
 - gradual steps; or
 - test drive.
- Mandate purchase of advanced life deferred annuity (ALDA).

If policymakers are paternalistic, need to ensure the right products are available.

- Joint and survivor provision
- Inflation protection
- Variable annuities?



Variable annuities raise the question: How much risk as you approach retirement?

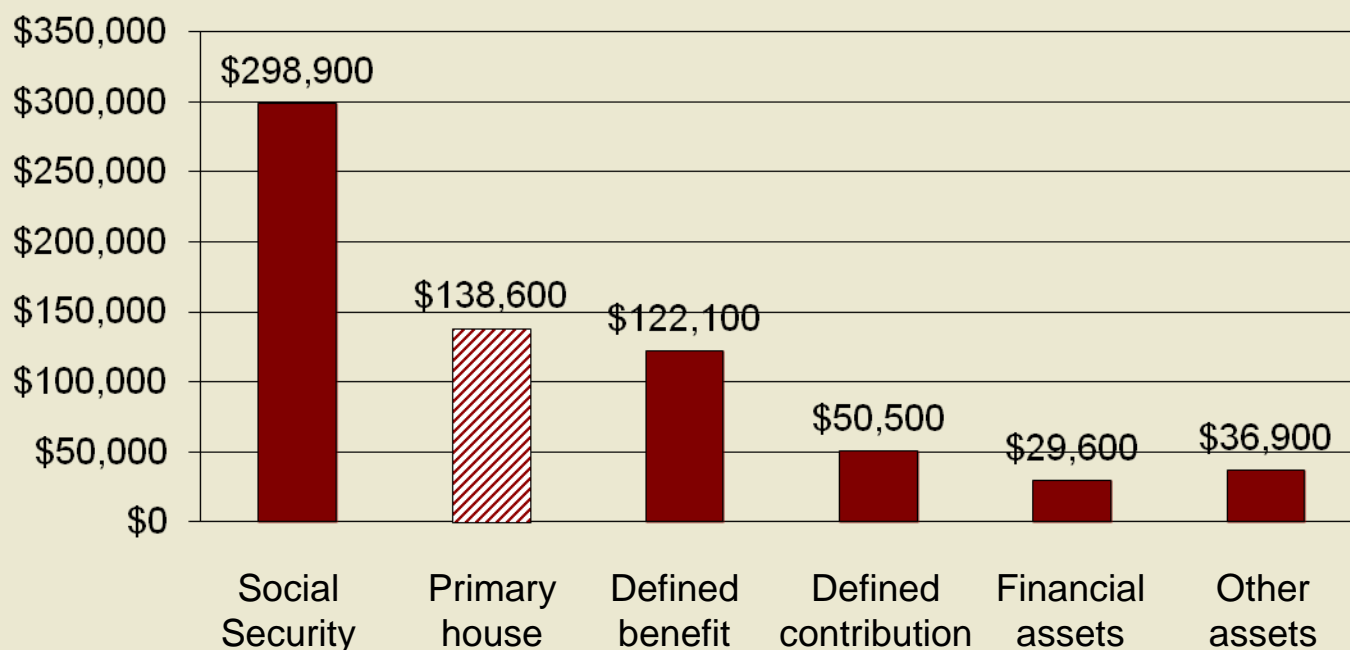


Note: MainStay funds only come in 10-year increments, and therefore a 2050 target retirement fund. It is, however, designed for the same age cohort as the 2045 funds.

Sources: Information for the funds come from each provider's site.

A final thought: need to expand discussion of asset decumulation to the house.

Wealth Holdings of a Typical U.S. Household Aged 55-64, 2007 *Survey of Consumer Finances*



Source: Author's calculations from U.S. Board of Governors of the Federal Reserve System. *Survey of Consumer Finances*, 2007. Washington, D.C.

Conclusion

- Annuities are increasingly important in a DC world, but few people buy them.
- The solution depends on the nature of the problem.
- If people don't buy annuities due to...
 - a preference for flexibility and control, no change is needed.
 - ignorance, education is the answer.
 - behavioral biases, defaults or mandates may be needed.