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To: Connecticut Retirement Security Board

From: Center for Retirement Research at Boston College (CRR)

Date: 6/9/2015

Re: Should an annuity be the default withdrawal option?

Connecticut must pick a default withdrawal option for its program, and its legislation suggests an inflation-indexed annuity with a spousal benefit. Unlike automatic enrollment, which puts participants in a plan where most of them benefit from participating, it is less clear that annuitizing all assets upon retirement will similarly benefit most participants. Practically speaking, good annuities are not available for uncovered workers in Connecticut, and account balances in the plan will be too small to be worth the cost of annuitizing for the first few years of the program. Thus, in the short-term, Connecticut should consider the extent to which annuities affect participation and should set up a commission to study the most suitable withdrawal option using data on workers who participate in the program.

The Lump Sum Option

If no wealth is annuitized, participants must decide how much to withdraw each month. On one hand, participants risk drawing income too quickly, and on the other, they run the risk of holding on too tightly to their assets and foregoing much-needed income. Drawing income from a defined contribution plan is further complicated by the potential of poor investment returns, rising prices, and unexpected expenses. The popular 4-percent rule provides reasonable income while preserving liquidity, but this approach presents considerable longevity risk. A more conservative approach, such as using IRS minimum distribution requirements, can lessen the risk of outliving one's money. However, this approach reduces income available for consumption, especially in the years immediately following retirement. A similar tradeoff exists with respect to investment risk and inflation – one can invest conservatively or buy inflation-protected bonds but both strategies reduce income.

Full Annuitization

An annuity eliminates longevity risk and also makes it easy to make a retirement spending budget. Since annuities pool mortality risk – i.e. make payments based on average life expectancy – they provide more income than other lifetime income strategies. Annuities also simplify the drawdown decision and help individuals overcome behavioral biases that cause them to either spend assets too quickly or too slowly by making regular monthly payments.

But annuities have drawbacks. Annuitizing all assets leaves nothing for unexpected expenses, a particular concern for workers who do not save outside of the retirement program. In addition, annuities are typically invested in safe investments with low expected returns, which prevents annuitants from benefiting during good times. When given the option, most 401(k) participants

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do not choose an annuity, a preference explained by rational motivations (such as a bequest motive or poor health), but also assumed to be influenced by behavioral factors (such as present-bias and loss-aversion). Another drawback in the short term is that the existing market for annuities is set up to serve high-net-worth individuals who expect to live a long life. As a result, annuities are not fairly priced for Connecticut's uncovered workers who will have a much lower life expectancy, on average, than existing annuity customers.

According to economic theory, annuities should be part of an optimal drawdown strategy. But the benefit of an annuity is greatest when no income is already annuitized. This theoretical prediction is reflected in the structure of national pension systems: most developed nations pay their national pension benefit in the form of an annuity, while employer and individual savings plans are not universally required to be annuitized. An uncovered worker in Connecticut earning median wages can expect to replace between 29 percent (at age 62) and 41 percent (at age 67) of his pre-retirement income with monthly income from Social Security. Workers who have paid off their mortgage by the time they retire also have annuitized income in the form of rent-free living in their house. As a result, the benefits of full annuitization are likely to depend on individual characteristics and preferences.

Partial Annuitization

Other options can balance the benefits of an annuity with the need to keep cash on hand for emergencies. Instead of converting all assets to an annuity, the default withdrawal option could, for example, annuitize half of participants' assets. Similarly, a deferred annuity – one that is bought at retirement and begins payments once an individual is in his or her 80s – can provide longevity insurance at a fraction of the cost of an immediate annuity. Uncovered workers in Connecticut who wish to annuitize can also delay claiming Social Security and, thus, “buy” an inflation-indexed annuity with a survivor benefit at a fair price.

Practical Considerations

Offering an annuity to uncovered workers poses practical problems in the short term. Most participants who retire in the first few years of the program will have very small account balances, which cannot be annuitized efficiently. Perhaps as a result of this and other considerations listed above, most state initiatives have taken a “wait and see” approach; in contrast to language stipulating auto enrollment, most proposed programs fail to specify a withdrawal option.

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