

AARP Solutions Forum

POKING HOLES IN CONVENTIONAL WISDOM: A NEW LOOK AT MAKING FINANCIAL DECISIONS FOR RETIREMENT

**MONDAY, SEPTEMBER 14, 2009
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**WELCOME:
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AARP PUBLIC POLICY INSTITUTE**

**SPEAKERS:
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*Transcript by
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Washington, D.C.*

JANET MCCUBBIN: Good morning and welcome to AARP. I am Janet McCubbin and I'm director of economic security for the AARP Public Policy Institute. The AARP Public Policy Institute is responsible for analyzing and developing policies on a wide range of issues related to the economic security, health and quality of life for our older Americans.

As part of our efforts to promote the adoption of sound economic and health policy, we have hosted a series of AARP solutions forums. And these forums serve as a venue for showcasing and openly debating a wide range of ideas. Our goal is that by working together, we will make significant strides towards ensuring not only the health and economic security of today's workers, but that of future generations, as well.

Many researchers and policymakers have given considerable attention to how to promote saving for retirement. And most of us have paid far less attention to how to help families manage their finances once they near retirement or are in retirement. And decisions that workers and retirees will face now and in the future are formidable. In the past, a substantial fraction of retirees could depend on a regular pension check with a guaranteed amount that would last their lifetime.

But despite all the jokes about our 401(k)s becoming 201(k)s, the decline in defined benefit pension and the rise of the defined contribution plan will mean that many workers will accumulate a sizable nest egg that they will need to manage throughout their own after they retire. At the same time, retirees are living longer, and they will need to ensure that their assets last for 25 years or perhaps longer, without needlessly depriving themselves of the enjoyment of their nest egg.

Anthony Webb of the Center for Retirement Research at Boston College is going to open our session today by assessing five key decisions that households in or nearing retirement must make. For each of these, Tony identifies the conventional wisdom about what people do, describes what people actually do, and then discusses what a more careful economic analysis suggests that what most people ought to do to ensure that they have income to last throughout their retirement.

You probably won't be surprised that most people don't do what Dr. Webb, the economist, says that they ought to do. (Laughter.) Therefore, our next panelist will elaborate on why individuals might have a hard time making decisions about managing their retirement assets, and what we might do about it. Lina Walker of our Public Policy Institute will draw upon the behavioral finance literature and discuss how we might entice workers to put some of their 401(k) nest egg into an annuity.

Pamela Perun of the Aspen Institute will talk about a proposal to use the Social Security program to improve the annuity market as well as the take-up of annuities by individuals. And Sandy Mackenzie of the Public Policy Institute will discuss how features could be added onto 401(k) plans so that they provide a guaranteed stream of income for life. And we'll try to leave

plenty of time for question-and-answers and discussion from the audience at the end. And with that, I will turn the floor over to Tony.

ANTHONY WEBB: Thank you very much. It is my very great pleasure to be here. What I am going to say represents my opinions and not necessarily the opinions of the Center for Retirement Research or Boston College or the AARP.

As I only have 25 minutes, I'm planning on focusing on three of the five key mistakes that households make. And I want to set the scene by asking you think of a household that has been working all its life, which has a regular paycheck every month, has got to the time and has accumulated a sizable nest egg. The household's paycheck stops at retirement; the problem is that the bills don't stop. The fundamental problem that the household faces is how to convert its nest egg into a monthly paycheck for life. And I think we really ought not to lose sight of that financial objective.

Now, the first mistake the households make is in relation to the Social Security claiming decision. Now, one can really isolate three separate mistakes here. The first mistake is that households simply retire when they aren't ready. If you haven't got enough financial assets, then if you're able to work, in terms of health and employment opportunities, then you really have to damn well carry on working until you are ready. (Laughter.)

Having said that, the other mistakes that households make are that they really fail to separate the claiming from the retirement decision. And households claim much too early. Now, based on academic research, which is available on the Boston College Center for Retirement Research Web site, my recommendation is that single individuals and married men should postpone claiming until at least age 68, more or less regardless of life expectancy. And I really emphasize those last three words. And those with financial assets who are able to exit the labor force prior to age 68 should use those financial assets to fund consumption in between retirement and claiming.

Now, there are some – I had a look at the audience list and there's one or two people who aren't U.S. people here, so I'll very, very briefly summarize the U.S. Social Security system. I realize it's old news to a lot of you. There are three basic benefits. There's a retired worker benefit, which can be claimed at any age in between 62 and 70. The full retirement age is 66. One has a 25 percent reduction if claiming at 62; a 32 percent increase if claimed at 70. The decreases and increases are approximately actuarially fair. And the program gives a 40 percent replacement rate for an average worker if he retires at age 66.

The second benefit is a spousal benefit. Now, I'll talk in terms of husbands and wives here – both husbands and wives can claim spousal benefit, but it's usually claimed by the wife. The spousal benefit, if claimed at age 66, is equal to 50 percent of the benefit the husband would have claimed, had he retired at age 66 – his full retirement age. It's payable to the extent that the spousal benefit exceeds the wife's own retired worker benefit.

The wife has to be at least 62 to claim it. The husband has to have claimed his own retired worker benefit in order for the wife to claim her spousal benefit. I realize that there are

all kinds of clever ways around this, but we don't go into that. There's a 30 percent reduction if claimed at 62. There is no increase if claimed after 66. And as I said, most claimants are women.

The third benefit is the survivor benefit. And this equals 100 percent of the husband's benefit if the wife is age 66 or older when her husband dies. And it's subject, if she's 66 or over when her husband dies, to a floor of 82.5 percent of the husband's primary insurance amount – that is, the benefit of the husband would have got had he claimed at age 66. And if the wife is less than 66 when her husband dies, the minimum benefit payable is 71.5 percent of her husband's PIA.

Now, the program confronts households with various tradeoffs. First of all, if the husband postpones claiming benefits, he not only increases his own retired worker benefit; he also increases his wife's survivor benefits. And the average woman is about 3 years younger than her husband; the average woman lives about 3 or 4 years longer than her husband. Therefore, the average woman can expect 6 or 7 years in widowhood. This is a very important, valuable benefit. And it's very effective at keeping widows out of poverty.

The problem is, if the husband postpones claiming his retired worker benefit, he also forces, in many cases, the wife to postpone claiming her spousal benefit. And the wife may have an interest in claiming her spousal benefit earlier rather than later, the reason being that the spousal benefit is paid not over the woman's life expectancy but over the shorter period, ending with her husband's death when the wife moves from spousal benefit to survivor benefit.

So how do people frame the claiming decision? Now, where I think people go wrong is that they frame the opportunity to postpone claiming 1 year and sacrifice a year's benefit in return for a larger benefit in the future – they frame it in terms of a risky gamble that the household will lose if they don't live long enough. So what I did – I searched on Google and I typed in "Social Security and break-even age," and I got 1,870 hits. (Laughter.)

This is one that I've chosen at random. I have no desire to pick on about.com and I hope that they won't be offended. But the article is like many others. It talks about break-even ages and how, if you postpone claiming benefits, you're losing a year's benefit with certainty; you'll only break – you'll get your money back if you live more than X number of years.

Now, this is how I and most other economists would like people to think of the decision: We have a single-earner couple who are entitled to \$1000 in benefits at age 66. They are both age 62. If they should claim at age 62, the husband's entitled to \$750 a month of retired worker benefits, the wife is entitled to \$350-a-month spousal benefit, totaling \$1100.

If they postpone claiming until age 63, the husbands gets an \$800-a-month retired worker benefit; the wife gets a \$375-a-month spousal benefit, totaling \$1175. The household's benefit goes up by \$75 a month. Now, how I would invite you to think of the transaction is that the household gives up \$1100 per month for a year – \$13,200 – in return for an increase in its lifetime income of \$900 a year.

I can label this, and most economists would label it, as a purchase of an annuity. I realize the “A-word” is not very popular. And therefore, one might frame it as an opportunity to increase the level below which the household’s income will never fall, however long it lives, however badly it manages its investments.

Now, why are annuities so valuable? There’s a whole literature that has a look at the value of annuitization. I won’t go through the literature in detail, but basically, annuities are a mechanism by which households, in aggregate, can consume money that would otherwise pass as unintended bequests. And there is a whole literature that compares the purchase of annuities with the optimal drawdown of unannuitized wealth. And it shows that households ought to place a very, very substantial value on the opportunity to purchase additional longevity insurance on actuarially fair terms.

So how do we change behavior? I have a couple of ideas. The first idea is I would really like to get people to stop talking about break-even ages. I think it’s entirely unhelpful. The second idea I would like to float is the possibility of nudging people in the right direction.

Now in the case of DB pensions, the law requires that if a person wants to claim a single life, rather than a joint life, annuity, he has to have spousal consent. And I’m throwing out the idea to you of maybe requiring spousal consent for claiming Social Security retired worker benefits prior to the full retirement age. It would force the couple to have a discussion and force the husband to explain to his wife what might happen after his death.

Now, the same analysis can be applied to the household annuitization decision. Now, as we know, the rates of voluntary annuitization are extremely low, and this so-called annuity puzzle has led to a cottage industry of explanations. Now I have just a couple of points to make on this. The first is I think we need richer more realistic models of the asset decumulation decision incorporating health-care costs. And these are just starting to emerge. I have to say, it’s not obvious that uncertainty regarding health-care costs will decrease the value of annuitization.

The second is that the counterfactual in all of the academic models of asset decumulation and purchase of annuities is an optimal drawdown of unannuitized wealth. Now, we know how badly households manage the process of wealth accumulation. I suspect that many households’ asset decumulation paths are very, very far from optimal, and that the losses from households not annuitizing are probably even greater than the calculations indicate.

So what type of annuity is best? Now, to the extent that households actually annuitize, they typically purchase nominal, fixed annuities. Now, the problem with these annuities is that even at a 2.5 percent rate of inflation, a couple age 60 can expect its real income to – faces a 43 percent probability of its real income halving during the course of its retirement. Now, it’s possible this is the consumption path that the household actually wants – they want to have great consumption early in retirement when their health is best or when they’re able to travel and so on. But what I think is going on is that when faced with the alternative of purchasing an inflation-protected annuity, the household suffers from sticker shock.

So imagine a rare household that's actually accumulated a million dollars in its 401(k). And this is very atypical; the average balance is many, many times smaller. The household might well regard itself as relatively rich. When told that the household can get \$50,000 a year from an inflation-protected joint life annuity, the household's understandable reaction is, well, I'm a millionaire; I shouldn't have to live on \$50,000 a year. And I think that this sticker shock undoubtedly contributes to the lack of interest in inflation-protected annuities.

The other puzzle is that variable immediate annuities – and I use the word immediate there because I'm not talking about variable deferred annuities – the sales of variable immediate annuities are also extremely small. We can talk about what the optimal allocation of household wealth might be between stocks and bonds. Maybe it's 50/50 at age 64; I don't know. But if the optimal allocation is 50/50 at age 64, it's unlikely to be optimal to the same household to put all of its wealth into a bond-like immediate fixed annuity 1 year later.

The problem with variable immediate annuities is obviously that they expose the household to risk of a very, very low income, if the household – if the market tanks or tanks for a number of years. And this risk is really quite hard to quantify in that we really don't have a good handle on what the future distribution of equity returns might be like. But they clearly have a greater place in household portfolios than they have now.

So how do you encourage annuitization? The experience of the U.K. is an annuitization mandate is highly unpopular. It's relatively difficult to set an annuitization as a default because a decision is irreversible in the sense that the 401(k) contribution decision is not. I think that there is maybe a role for the advance life-deferred annuity. This is a product which is purchased at age 65 or earlier, and which kicks in at some advanced age. It's a means of capping the risk of living exceptionally long. It's longevity insurance with a large deductible.

Another idea that Lina's going to touch on in a minute is the idea of automatic trial income. And I'll ask my other partners to tell you a little bit more about that and Lina will discuss it. I think that we can also learn from the success of guaranteed income annuities, which are not truly annuity-like in that they give households the opportunity of reclaiming their capital on death or surrender. But we might want to have a look at what features make them attractive and see if there's a means of replicating those features in other annuities.

The third area I'm planning on touching on is the allocation of unannuitized wealth. So clearly, not all households want to annuitize – not all households want to annuitize all, or in some cases, any of their wealth. And the question is how should they allocate the rest of their wealth between stocks, bonds and perhaps, cash and short-term deposits?

And the conventional wisdom is that stocks are the riskiest assets, bonds are less risky and offer lower returns, and cash and short-term deposits are absolutely risk-free. And if you look at this little table, this shows the average return and the standard deviation of the return on stocks, bonds and cash. And the takeaway message from this graph, which is wrong – (laughter) – is that cash is the least risky asset. And what happens is that we observe that households invest a large portion of their wealth in cash and short-term deposits.

Now, I'd invite the audience to make the distinction between the return of capital and the return on capital. Now, cash and short-term deposits guarantee a return of capital, but they don't necessarily – or don't guarantee a return on capital. And here we have a graph of the nominal and real returns on six-month CDs over a 30-year period. And you can see the rate of return has been all over the place. And a household using cash and CDs to generate a retirement income is going to find that its income has, likewise, been all over the place.

Now, in contrast, bonds, if they don't default – and government bonds don't default – they may guarantee a rate of return on capital. But the problem is that they cannot guarantee a return of capital. And the reason that it is a mathematical, inverse relationship between the bond price and interest rates. And here we have a graph of the yield and price of 30-year Treasury bonds over a 30-year period. As what you can see is when the yield goes up, the price goes down and vice versa.

Now, there's a special investment – Treasury Investment-Protected (sic) Securities. And these guarantee the household a real rate of return on capital. And the risk premium for these products is relatively small. And here, I've graphed the 30-year Treasury bond, less anticipated inflation and the – sorry – the yield on the 30-year Treasury bond – 30-year Treasury bond less anticipated inflation, and the yield on 30-year TIPS. Now, you can see that the 30-year TIPS will yield exactly what the 30-year Treasury bond might, minus anticipated inflation.

So I would argue that the household managing wealth decumulation in retirement ought to prioritize return on capital over return of capital, and the ultimate guarantee of the return on capital is an investment in TIPS. And if you knew your consumption needs in advance, what you could do is assemble a portfolio of bonds of various durations and simply wait for the mailman to bring the check. The problem is that, in practice, the consumption needs are uncertain. People face medical expenditure risk. And one might, therefore, want to invest part of the household's wealth in cash and short-term deposits.

So why are households so fixated on guaranteed return of capital? Now, one possible explanation – by the way, I think this is quite plausible – is myopic loss aversion. People are much more sensitive to losing the capital they've saved rather than having a lower-than-expected income. The other problem – and this is something which I think can be rectified – is that there's maybe an excessive focus on the stocks of wealth rather than the consumption stream that the wealth can generate.

I get my quarterly 401(k) statement. It tells me how much is in my account – what my account is worth. And that is, frankly, not a terribly relevant number. (Laughter.) The numbers I ought to be focused on is how much consumption that wealth will buy me in retirement. And that number never, ever features on my quarterly statement.

So maybe there's a way of rejigging statement and information so that people focus on the ultimate objective of retirement saving rather than the number in the account at any one point in time. Now, I was given a 25-minute slot. I'm not going to touch on the other two mistakes households make because these three tie in best for the other speakers.

How do we get from where we are to where we want to be? I think any strategy probably involves three things, and they're probably not mutually exclusive. First of all, we need financial education. Secondly, we need appropriate defaults – and I'm a great fan of nudge. And thirdly, we need innovative financial products. And here, the other speakers are going to come up with a couple of ideas. So thank you for your time, and I'll hand you back to the chair. (Applause.)

MS. MCCUBBIN: Next, we have Lina Walker from the Public Policy Institute.

LINA WALKER: How do I get my slides up? (Laughter.) Oh, it's okay. Thank you very much, Rita (sp). Well, thank you very much, Tony. I think Tony did a wonderful job of laying the groundwork for us in describing the disconnect between what people are doing in planning for retirement and what they ought to be doing. So what I'll be doing right now is just discussing and offering a practical way to get us from where we are to where we want to be.

This proposal was written when I was at the Retirement Security Project. And credit goes to my other coauthors, Bill Gale, Mark Iwry and David John. And some of you might know the names from some of the proposals that have been circulating around town recently. Now, Janet mentioned that there's a lot of interest and concern about the decumulation decision, and in fact, today, myself and the rest of the panel will be talking about our strategies to increase annuitization.

And there's a reason why this topic is of particular interest. As many of you know, the retirement landscape is changing. So we're moving away from lifetime pensions, obviously, with defined benefit plans and instead, we're entering a world where most workers are saving in their 401(k) plans. This is not a surprise to any of you in this room.

But what's really important to remember in this new system is that for most workers, the retirement – the assets in these 401(k) or defined contribution plans are probably going to be the primary form of retirement savings. And when you've been saving and accumulating in these accounts for a long period of time, by the time you reach retirement, you will have amassed a large sum of – a large amount of money in these accounts. And so the decision about what to do with them is a really high-stakes decision.

And the issue is, you don't know exactly how long you're going to live. And thinking about how to allocate these resources so they last the rest of your lifetime is not an easy problem to solve. It's not easy for most individuals – it's not easy for us to spend a lot of time thinking about this problem. So the fact is that in this new environment, households are facing a new and different set of risks from those individuals who used to have lifetime pensions; you face the risk of consuming too much too soon and there's a possibility of outliving your resources.

But also, there's another risk, which is equally dire. You face the risk of being too conservative in your consumption and giving up possible – too conservative in your spending and given up possible consumption in retirement that could have made you better off. So many of us here believe that annuities are a way to circumvent and mitigate some of the risk. And we know that there are benefits to annuities, or lifetime-income products, more generally. The first

is that you receive payments for life. It doesn't matter how long you live; you receive your monthly payments and that's a good thing.

It simplifies your retirement planning problem and mitigates one of the risk. Annuities also have an insurance component to it, which enables you to benefit from what is called mortality credits. And what this simply means is that if you live a long time, with annuities, you end up being able to consume more than you otherwise would have without annuitization. But we know, of course, that demand is low and that many individuals are averse to buying an annuity.

Now, if you look at current retirees, about 2 percent – 2 percent – of their primary income comes from private annuities. The question is, is this pattern going to hold for future retirees, who are saving mostly in their 401(k) plans and they don't have the benefits of a lifetime pension through a DB plan? And we believe that the answer is yes. But the other, more important question I think that we need to think about, and we have thought about very carefully, is that, are there gains to annuitizing a larger portion of your retirement assets? And we believe that the answer to that question is yes.

Now, let's think about some of the reasons why people aren't buying annuities. We know that there are differences in need. So not everybody needs to annuitize all of their retirement assets and the amount that you need annuitize in private annuities would be different, as well. Many of us receive Social Security benefits in retirement and Social Security is an inflation-protected annuity. So for those with low household income, Social Security provides a very nice replacement rate. And for those households, they might not need to purchase additional annuities from the private market.

For some individuals, even in this new world, you might have some defined benefit pensions – say, if you worked for AARP, for instance. (Laughter.) And so for some of us, we might not have to buy extra annuities. On top of that, we might want to hold some liquidity – some assets – to pay for uninsured medical expenses or we want to leave some funds to our family members. But you couple these two reasons and you can explain a big chunk of why people aren't buying annuities.

But that's not the only reason and we're well-aware of that. We know that the market for annuities is imperfect in the sense that the pool of individuals buying annuities is small and select, and they tend to be longer-lived. So annuities are priced to reflect that sample, which means that the prices are higher than what it would be otherwise. So it's not a great value for somebody who has an average or less-than-average life expectancy.

We also know, and we're learning, that behavioral obstacles can get in the way of how individuals perceive annuities. I think that this is something really important to think carefully about. There are a lot of various reasons why people are averse to buying annuities. And we don't fully understand all these reasons yet. We know that there are concerns about loss of control. There are frame of reference biases. There's also just plain unfamiliarity with the product.

Now, for many of us, we're familiar with, you know, stocks and bonds and different savings and investment options. And there are lots of benchmarks on the Web that can tell you if your particular investment is doing well. It's not so clear with an annuity. So if you're somebody with a 401(k) plan and you get to retirement and you have your different distribution options and in addition, let's say, your employer offers you the chance to take distribution as an annuity, it's kind of difficult to compare the yield on an annuity to the yield on your other investment options, simply because you're not familiar with the annuity.

And so there is a tendency of people to go with what's familiar and that might be one reason why people are not buying annuities. Again, it's not all. It's also that the process is difficult. There are multiple steps to buying an annuity and as we know, people like simplicity. The harder it is to buy something, the less likely it is that you will use that.

So what this means, though, if you look at this list of reasons, is that if there is some way to improve market function and improve prices – if there is some way to mitigate or circumvent some of these behavioral obstacles, it could be very well be that demand for annuities might increase and the individuals will stand to gain from increasing the proportion of their retirement assets that's annuitized.

So I think it's – when we were developing our proposal, we paid particular attention to biases and we wanted to identify, insofar as we could, what could be driving some of the low demand. Now, this is still at the early stages of inquiry. There has been a lot of experimental evidence on biases in general, but not as they apply to annuity and annuity choice. But there's some growing evidence that framing matters.

So there are a number of experiments that look at different contexts for framing. The first is an experiment that looked at annuities and presented them as an investment versus a consumption frame. And in an investment frame, you talk about annuities in the way you would talk about other investment options. There's a return – you invest the money and there's the return on it.

And what they found was that when you present it in the investment frame, people perceive the annuity to be a risky proposition. And on top of that, it's a risky proposition that comes with no risk premium. And so it was a bad deal when you compared it to other investment options. But switch the frame – they started talking about annuities as income, as ability to make your monthly payments. And suddenly, the appeal of those annuities rose dramatically, by over a 20 percentage-point difference, which is not a trivial difference.

There's also some experimental evidence that if you present annuity in a negative frame relative to other investment options, then you're not likely to pick the annuity. And in the experimental work that I've done, we took a different approach. We looked at the way – how the – how you frame your assets or endowment, and how that would affect your annuity decision. And we found that when we talked about their assets and their endowment as a lump sum, or as an account balance, individuals were averse to annuities.

But switch the presentation and talk about your assets as the potential to fund or to support a particular stream of payment, as Tony alluded to earlier, and people seem to value the annuity more and were more likely to choose the annuity option. So taking in mind all of these obstacles, when we designed our proposal, we wanted to make sure that, first of all, the process was simplified. And we did that through the use of defaults.

And so instead of having to go out and shop for annuities when they make comparisons, your assets will be defaulted into an income payment plan. Now, Tony and others – you know, we also believe that this in itself is not enough. Unlike savings, which everybody agrees is a good thing, annuities is that “A-word.” So we – in addition to defaults, based on the experimental evidence that we’ve seen, you need to reframe the discussion as well, and you need to focus on lifetime income.

But what we believed, however, was that it’s not enough to have people attend seminars, to give them printed material to read, or to just talk about it; the way you get people to realize and internalize the new and different concept of lifetime income is to have them try it out – learn by doing. And this is what we – why we give them this opportunity by allowing them to test drive, to experience the annuity for a little while.

And we also need to include prices. If you don’t have a sufficiently large pool you’ll still face the problem with prices. And we have a large pool of participants and a large pool of funds through 401(k) plans, so we proposed this idea – this trial income – through 401(k) plans. And we also need and wanted to acknowledge that there might be differences in need. And so we give individuals the flexibility to opt out of the proposal for whatever reason, maybe because they are sufficiently annuitized or their account balances are really too small to warrant annuitizing their 401(k) assets.

So this is the proposal. We call it the automatic trial income payment plan. So at retirement, you default a substantial portion of your 401(k) balance into an income payment plan. You have the ability to opt out, but if you do nothing, you start to receive monthly payments. You receive them for 24 months. This is temporary. At the end of 24 months, you can elect a different distribution option. If you decide this isn’t for you, you can opt out. Or if you do nothing – whether by choice or because you never got around to making a decision – you are defaulted into a permanent income plan.

Now, I just want to note that, as Tony said, in the U.K., you can mandate annuities but in the U.S. there is a completely different appetite for mandates. So this proposal is not a mandate on employers. We’re trying to encourage employers to offer this as a distribution option. And it’s also not a mandate on employees; we allow the employees the opportunity to opt out.

Now, there’s another feature about this plan that’s worth mentioning. I mean, I think, you know, if you think about what it will be like for future cohorts of retirees, when you get to retirement, you have this chunk of change in your 401(k) account, and figuring out what to do with it is a high-stakes decision. And so what this trial plan allows is it gives you time – it buys you a little bit more time to think about what you want to do with your 401(k) assets and what’s the best distribution option for you.

But more than that, and perhaps more importantly, what this plan offers is that, for many individuals, they don't run into annuities in their day-to-day lives. And so this is an opportunity for them to acquire more information about a product which they really know very little about. And it gives them an opportunity to consider this product – the merits of this product – relative to something that you're more familiar with – you know, stocks and bonds or lifecycle funds, or whatever, whatever the other investment options are. And I think that's the key point of this proposal.

Now, we admit that, oh! (Pause, technical difficulties.) Should I keep going? Yes – the right arrow. Yes, thank you. Okay, we admit that we haven't dotted all the I's and crossed all the T's, and the fact that there is a lot more thinking and talking that needs to be done before this proposal can be implemented well and sustained for a long period of time. So one of the first things we need to do is just keep talking and educating people about the benefits, the merits and the risks of annuities.

But I think you shouldn't just focus our efforts on consumers. There is a lot of misconception from plan sponsors and financial advisors as well. So the conversation has to take place at a larger scale. We also need to think about how, in order for the proposal to be successful, you have to get employees to participate in it. And so we need to think about incentives to get employees to adopt this default trial income payment plan.

And one thing you could imagine would be, you might offer a set of qualified options – you know, trial income products that meet certain specifications and that, if the employer provided something that met those specifications, they would be protected from fiduciary liability. There probably need to be some regulatory modifications to 401(k) plan rules as well, particularly depending on the age at which you trigger these trial income options. So if it's under 55 or over 70-and-a-half, you need to think about how that would comply with existing 401(k) regulations.

But I think, more importantly, I mean, we also need to think of a way to safeguard the assets – safeguard retirees' assets. If you have a lot of people investing in annuities or alternative trial income products, you have to think – which will be long-lived – you need to think about how you ensure the safety of those assets and perhaps even provide a federal annuity resource or clearinghouse where people can go to go to and find more information about the different annuity options that provides greater transparency on pricing and increased access.

Now, if there is one thing that you take away from this presentation today, I think that you want to reinforce – and we do try to make a strong point of this in the paper – is that we're not promoting annuitization, per se. We don't say – in fact, we don't believe at all – that everybody needs to annuitize all of their retirement assets, or a big chunk of them. That's not the case.

What we're simply saying is that we're now functioning in a different kind of retirement system and the risks are new and different. And so you need to develop different sets of tools when you are operating in this new world. Now, one of those tools would be annuities, but

annuities have always had a bum rap, so to speak. For whatever reason, because of misconceptions or biases, there has been a perceived – there is this perception that they are not as valuable as they actually are.

And so what we're trying to do is just level the playing field for annuities. And ultimately, the goal of this proposal is to give consumers more information about the different distribution options that they'll at retirement in the hopes that it would allow them to make better choices, which would improve their retirement security. Thank you. (Applause.)

MS. MCCUBBIN: Thank you, Lina. Next we'll have Pamela Perun from the Aspen Institute.

PAMELA PERUN: Thank you. Good morning, everyone. It's a pleasure to be here today. In the interest of full disclosure, I would like you to know I'm an employee benefits lawyer and, in part, my observations are based on working over 10 years with actual employers and actual plans.

I currently work on pension policy as the policy director of the initiative on financial security at the Aspen Institute. And I want to describe to you, first, a little bit about our work. For over 4 years, we worked with CEOs and design teams from every corner of the financial services industry, as well as with policy experts, to design a better American system for saving, one that includes everyone, but is especially focused on low and moderate-income Americans.

Our product was savings for life, formerly known as "George" (ph). I have provided some copies in the back. I apologize for not making more available; we have just moved to One Dupont Circle and haven't unpacked our boxes yet. So if you would like a copy, please let us know – either give me your card or leave your card in the back and we'll make sure that you get one.

Savings for life is intended to be a seamless lifespan savings system composed of four complementary vehicles: child accounts to fund the transition to adulthood, home accounts to save for a down payment on a home, America's IRA for those without a plan at work, and what I am here to talk about today – security plus annuities to translate savings into income that lasts for a long time.

As our previous speakers have mentioned, we all know that annuities are the missing piece of the retirement proposal – I'm sorry, retirement puzzle. They are virtually absent from 401(k) plans and few people choose to buy the traditional annuity – an immediate fixed life annuity. Industry statistics show that the market for annuities both inside and outside employer plans is underdeveloped. So what we need is a better market for annuities.

Tony and Lina have given us an excellent review of some of the cognitive difficulties that people have in thinking about annuities. But we at IFS believe that it's important to understand that we can't fix the problem by focusing solely on people. There are important institutional, market and regulatory failures that contribute to the under-utilization of annuities. These must be addressed as part of any effort to expand that take-up of annuities. They include problems in

the pricing of annuities as well as the failure of brokers and financial planners to educate consumers about the benefits of annuities and to help them purchase them.

In addition, there are regulatory challenges. An annuity is a long-term investment where the solvency of the guarantor is of utmost importance. Annuities are regulated under state, not federal, laws, and protection varies depending on the size of the annuity and the residence of the annuitant. When insurance companies fail, there are guaranteed funds available, but recovery can be a slow, complicated, and not always a fully successful process.

At the same time, there are many policy issues to be resolved around annuities. Many advocate for expanding 401(k)s to include annuities either through a mandate or a default. But that is not easy to do from either the employee or the employer perspective. First, young people will not appreciate being locked into an annuity, and not all older people need or should have one. From a legal perspective, employers face fiduciary liability when annuities are added to their plans. But even if we could solve the legal liability problem – and it's not clear how to best protect participants choosing to annuitize through employer plans – we must be careful not to kill the 401(k) goose that lays the golden egg, as we have already done with defined benefit plans.

We must remember that 401(k) plans depend on the good graces of employers, while participants largely pay for their costs. Every bell and whistle that we add to these plans multiplies the employers' administrative burden, while their costs reduce the return to saving for participants. I personally fear we are reaching a tipping point with these plans where only the largest employers will continue to offer them while other employers bail out, exacerbating the serious coverage problem we already have in 401(k)s. So I ask you seriously, from the bottom of my employee-benefit lawyer's heart – (laughter) – to consider whether employer plans are actually the only, or even the best, channel for delivering annuities.

And that is what we asked ourselves, because we are firmly committed to having savings last a lifetime. So we asked these questions: What can we do to deliver annuities to people in ways that make sense behaviorally, if not in a 401(k) plan? And who can we trust to be the intermediary between the industry and the purchaser, if not the employer?

Well, the answer turns out to be quite simple and, we think, elegant. We've propose a public-private partnership to deliver annuities at a critical period that is right at retirement, in a way that is facilitated by a trusted intermediary – the government, through the Social Security Administration – and at a low cost. We use Social Security – a universal, familiar, popular program already providing annuities – to sell what we call “starter annuities.”

We use the private market to underwrite group annuities purchased through the Social Security Administration and we use the federal government as an intermediary and facilitator between the consumers and the private market, to market and distribute annuities, provide administrative services, and select annuity providers. Here's a little diagram of how it would work.

First, we have a new retiree coming to the Social Security Administration to apply for benefits. And as part of that enrollment process, the new retiree receives information about how

he or she can purchase additional Social Security-like income. We engage a private call center through the private sector to be available to answer the retiree's questions about how to purchase one of these annuities and answer any questions that they may have. For those who sign up, the annuity premiums go in bulk to the private-sector annuity provider that the Social Security Administration has selected, while retirees receive, as part of their monthly Social Security benefits, an additional layer of Social Security-type income right in that check.

Here are some of the basic features. Let me assure you that our program does not turn Social Security into an insurance agency; what we are proposing is a true public-private partnership to deliver, basically plain, vanilla annuities. These annuities are immediate inflation-adjusted annuities that provide lifetime, guaranteed income on top of Social Security. In order to facilitate or to encourage annuitization decisions, they are available only in the first year of receiving Social Security benefits.

And to keep them within the realm of starter annuities, on the theory that people can always go out and buy additional annuities later, if they feel that they need them, we restrict the purchase amount to \$100,000. As I said, payments are added to monthly Social Security benefits and the government chooses the annuity provider or providers, depending on the take-up rate, through a competitive bidding process and provides administrative services for these annuities.

In other words, the private insurance company doesn't need to figure out who's alive, who's dead, where people live; all of that is in the realm of data that the Social Security Administration already collects, and so that helps minimize the cost of annuities. And that helps the private sector underwrite these annuities on a group basis at a very good cost.

Here are some of the benefits for workers. We think this is a wonderful time to educate people about the benefits of additional lifetime income at a critical period – the first year of receiving Social Security benefits – when people are actually confronted with the reality of how much Social Security income they're going to get for the rest of their lives and how much more they might like to buy.

The annuities are simple and easy to understand as an additional layer of Social Security-type income. In fact, we don't even need to use the "A" word; we can just ask how much more Social Security income would you like to have? And they are lower-cost annuities. We've eliminated the broker, and the government reduces administrative expenses.

And here are some benefits for developing a robust annuities market. As baby boomers reach Social Security normal retirement age, there are roughly 4 million potential customers each year who will be educated about annuities through this program and have the access to buy a starter annuity. At just a 10 percent take-up rate, we would triple the size of today's annuities market.

The benefits to society are many and they come without endangering the vitality of 401(k) plans. We provide education about the value of annuities and we can secure the retirement income of millions of Americans. And finally, we can help the private life annuity market develop to meet the needs of an aging America. Thank you. (Applause.)

MS. MCCUBBIN: And next, we have Sandy Mackenzie of the Public Policy Institute.

SANDY MACKENZIE: Good morning. This a brief outline of the talk. First, I'll begin – and I'll go over very quickly – some of the consequences of the decline of traditional DB pensions. And I'll be quick because I think we've already had a fair bit of discussion of that, and then go on to the pitfalls of phased-withdrawal strategies, which is what you need to do if you don't have enough in the way of a defined-benefit pension or other annuities, and then discuss two 401(k) add-ons, as I call them, that, to some extent, mimic the traditional DB pension. I stress to some extent because they certainly don't capture every feature of it. And finally, I'll conclude.

I think it's quite telling that, on the one hand, in 2007, close to a third of the older American population was still getting income from a defined-benefit pension, with a median value of a little over \$10,000 – that's not trivial. But if you look at the other end, the workers' end, only 17 percent of workers are actually contributing to DB pension plans right at the moment, and I calculate that in the private sector alone, the rate of participation is something on the order of 12 percent.

Just to acknowledge a point that Gene Steuerle was fond of making, DB pensions are flawed in certain respects, and the basic problem is that if they have – the investing provisions are very severe, then you have to work with an employer for a long time to really come away with an appreciable accrued pension. And it's theoretically possible, at least, that you can work in this country for 5 or 6 years in sequence with employers that provide these pensions and come away with virtually nothing.

On the other hand, if you are a career person at a particular employer, they substantially enhance the longevity insurance you can receive. As everyone has said, the 401(k) plan is not yet mature; when it is, when we reach a steady state where everybody has been contributing throughout their career, the average size of balances is going to be very large indeed, creating, in principle, a very large market for annuities and other distributional products.

However, other things being equal, this is also going to lower the share of retirement wealth that is annuitized, which can only decline. People have pointed out that this issue of annuitization and under-annuitization doesn't really arise for lower-income Americans because they are naturally highly annuitized because of Social Security.

Will demand for annuities grow? We discussed this as well. I think it will grow somewhat – just the availability of these huge balances – you know, some people are going to buy annuities. Group annuity premiums may drop. There may be arrangements where employers will go out and buy premiums on a group basis – the kind of thing that Kelli Heuler has been promoting.

At the same time, it's conceivable that with more financial education, the general distrust of annuities may abate somewhat. But reasonably speaking, we can assume that managed

drawdowns are going to become – sorry, will remain popular, and in fact, conceivably could become more popular if people don't annuitize a significant share of their 401(k) plan.

As I say, the standard approach, unless you're very highly annuitized, to the decumulation phase – managing your money in retirement – is relying on what we call phased withdrawals. The biggest decisions to be made, obviously, are how to invest the nest egg and then how quickly to encroach on it, or I suppose, whether to encroach on it or not. The retiree that relies on drawdowns, of course, faces two fundamental risks. One is investment risk and the other is longevity risk.

I start, in my work, by assuming that we can assume away, or rule out, longevity risk. We just make the very fanciful assumption that we know when we're going to die. (Laughter.) The point of making this is not because I believe it, but because it demonstrates that even if you make this ridiculously simplifying assumption, the problem of managing drawdowns is not a trivial one.

I ran four Monte Carlo experiments using four withdrawal rules on a portfolio that was 50 percent stock and 50 percent bonds and I took data on rates of return just from the whole American experience, really, from 1929 to, I think it was, 2007. So rule one is constant real withdrawals until you simply run out or until you kick the bucket at age 90. Rule two is withdrawals equal to a specific asset share, like 5 percent. Rule three is adjusting withdrawals for remaining life expectancy; as you get older, your expectancy declines and the rule says you can withdraw more.

And then finally rule four, which I'll explain a bit, is like rule two but has an adjustment for financial market performance. Just briefly, I've commented on rule three, but rule four, basically what you do is you establish a benchmark path for the retiree's asset holdings. So if they started off with a million (dollars) in one year; the following year, they might be 970,000 the year after that; 945,000 the year after that, and so on.

In effect, this is a desired path which you wish to stay close to. When actual holdings exceed the benchmark, you can consume more; when they fall short of it, you have to consume less. So in a sense what you're doing is targeting a certain rate of decline your assets. You don't want it to be too great; you don't want it to be too little because that's a waste.

Okay, basic lessons: The simpler rules – perhaps this isn't a great surprise to you – rules one, two and three simply don't perform well. What happens is that, in rule two for example, either you consume a great deal, but then there's a huge unintended bequest that happens when the stock market happens to boom, or in the case of rule one, depending on rate of return – sorry, on the withdrawal rate you assume, you can simply run out of money in the last 4 or 5 years of life.

Rule four does seem to work reasonably well, but rule four, I think, requires two important things. One is discipline; remember, the money is still in the retiree's hands. And the second is some degree of financial acumen. Basically, you have to sit down and figure out, you

know, okay, how much can I adjust my consumption for when the market is very good or when the market's declining?

Another approach would be simply to not invest in the market at all and invest in bonds and then the problem of instability is lessened, although not eliminated. But the cost of that is a low average return. My point in talking about this is not to argue that a phased-withdrawal strategy is dumb or stupid necessarily; it depends in large part on how efficient the annuities market is. But it simply can't deal efficiently with longevity risk. If you know when you're going to die, maybe it's not so bad, but otherwise, you've got a bit of a problem.

And the obvious problem is the do-it-yourself approach to longevity insurance is to make an extreme assumption about how long you're going to live. I'm going to live to 95 or 100. Well, that's fine and that deals with that problem, but it deals with it at the expense of, basically, constraining your consumption as Lina was pointing out. If you assume average life expectancy, as some financial planners apparently do, that means that, on average, you'll exhaust assets about half of the time. And that's clearly a foolish assumption for a cautious person.

Okay, now I get to the two 401(k) add-ons. There are two kinds: one called a guaranteed income, or variable annuities with an income guarantee. And these are not like traditional annuities. There's no longevity insurance; they're basically an investment vehicle. And the second is what we call in-service annuities.

Okay, starting with the first, this product basically, in effect, grafts a variable annuity with a guarantee onto a 401(k) plan. And the guarantee can work in various ways, but the simplest way to assume it works is that you'll get, say, 5 percent of whatever the highest account valuation you've recorded in the past. These guarantees, it is very important to understand are on nominal, not on real terms. So the guarantee applies for the rest of the account holder's life, so it provides a kind of synthetic longevity insurance. Any positive balance goes to the holders of estate.

The minimum guaranteed income is going to depend a lot on financial markets. It can become very high if markets are buoyant and vice versa. The other catch is that the guaranteed income gets reduced anytime you withdraw, in a given year, more than what is guaranteed to you. The base from which the guaranteed income is determined gets reduced.

How does this perform? I simulated two withdrawal rules. Rule one was simply to withdraw only the guaranteed amount. So you never run into the problem of having to – you don't encroach on the amount that is guaranteed you. And then rule two is maintain a constant real withdrawal, and then, when you can't do that anymore – when there's no money to pay you, you rely on the guarantee.

Rule one is really not that sensible because it means your consumption is automatically going to vary quite a bit over the course of your retirement lifetime. So I think it makes sense to apply a rule where there is an attempt made to make the income constant in real terms – or withdrawal constant. I hope these diagrams aren't too confusing. Maybe the best one to look at is, just, the first one. This shows the percentile outcomes.

And roughly, you can kind of average outcome of – I should say that initial outcomes were 25 (percent). You can have an average outcome, if the stock market really does you proud of 37, or you can have an average income as low as 17.2. So stability is not the hallmark of this particular approach. This is looking at the average withdrawal over the last 5 years. And again, you can have a huge range. So you don't run out of money it looks like, but again, there's not a great deal of stability.

Looking at rule two, as you might expect, basically, as long as there's money in the account to pay the person \$25,000 in real terms every year, there's a constant withdrawal. So in about half of the scenarios, people get \$25,000 all the time. In about a third or a fourth, that drops off. And in the last 5 years, again, you can have this problem where withdrawals become really low.

The basic point is that once you run out of money, you benefit from the guarantee, but if you've been spending more than what's guaranteed, then the amount of income you are guaranteed gets pushed down very low. That's why these numbers are what they are. So again, I'm not sure how satisfactory a stabilizing or smoothing instrument is.

In-service annuities – the basic idea here, which has also come up, is that contributions go straight, effectively, by a deferred annuity – every contribution you make. And you make these contributions over a period of, say, 20 years from age 45 to 65. So every month, the money is deducted from your account and instead of going from a growth fund to this fund or that fund, it basically buys a future income that starts at some future date, like age 65. Premiums are largely determined by interest rates and also by how close you are to retirement.

But the basic benefit that you get from this is that you're annuitizing very gradually. Instead of having to annuitize all in one go, at a time, for example, when interest rates are low, by annuitizing gradually, you get something like, what's it called, stock-purchase averaging; you're not stuck with an annuity that's very expensive. It's likely to be an average. The income that you get obviously varies at the level of interest rates and it declines with age.

I say a guaranteed future may apply – in my little simulations, I assumed it didn't, so if you die, you lose what you've already contributed. Secondly, I also simplified – this may be a gross simplification – but there was no change in longevity; people weren't living a – average life expectancy stayed the same over a period that people were contributing.

Again, there's the average premium that I calculate and it doesn't vary all that much. There's an 80 percent chance that it will be within the range of \$4 – \$4.25 to \$4.82. And the reason it's so low is that they're deferred. You're buying an annuity that doesn't start for some years after you've purchased it, in effect, and in these examples, I assumed no guarantee. So again, if you die, the insurance company or whatever picks up the money.

And this is the premium for just 1 year. And you see, as you might expect, the variance in the premium for one year is much greater than the premium you get if you annuitize gradually. That's the basic innovation, I think, of this product. Now, having said all this, I think that

Hartford or Prudential or somebody are still trying to market this. I don't know that there's any market yet that's developed. That's not the case with the first product, where there is a market.

So my conclusions would be, as my colleagues have said, Social Security may well provide enough annuitization for many. For others, it could be very desirable but there is the basic issue of the fear or distrust of annuities. The 401(k) add-ons may be an improvement in certain respects, depending on its costs – and this is something that I haven't gone into – the ISA appears to be superior to the other product in that the income it generates is more stable.

And then finally, I conclude that if satisfactory products like these are not available, you need to rely on a variant of rule four and successful application requires both vigilance and self-control. So I'll stop there. (Applause.)

MS. MCCUBBIN: Well, I have a lot of questions for the panel – (inaudible, off mike) – timer to make sure we have enough time for you. Why don't I open up to questions from the floor? Does anyone have a question?

Q: One of the concerns that is articulated about the annuity market is that it's overpriced because annuities tend to – (inaudible, off mike) – live longer than average; how does one go about demonstrating that, that is no longer the case? I don't know if that phenomenon is reflected in the life expectancy assumption or the price of the annuities or it's built into the fees, but how could you, using today as a snapshot, show at some point down the road, through, perhaps, the successful implementation of some of these programs – (inaudible) – this is no longer the case?

MS. MCCUBBIN: I think both Lina and Pamela have, as a goal in their proposals, to improve the annuity market in that regard. So did you want to comment on the question?

MS. WALKER: Sure. That's a very good question. Thank you very much. I didn't catch your name.

Q: Oh, I didn't say it. It's Bill Sharon, nice to meet you.

MS. WALKER: Bill – thank you for the question, Bill. So this is a good question. I think that, in general, the annuity market has evolved over time. And I think that there has been a lot of innovations in the market and prices actually have improved over time in most annuity products. But there is still that adverse selection problem that would make it more expensive for the average or shorter-than-average-lived person.

So your question is, specifically, at what point do we know you're at this state where you're getting an actuarially fair value from the annuity? In truth, there are different models that could go about estimating that. In terms of the annuity, it's not clear to me that the goal is actuarially fair. You know, there would be some built in from administrative cost. What you want to do is bring the cost down so it's in line with the gains that the individuals would receive from the annuity.

And it doesn't – in fact, there could be, even, some gap between actuarially fair and what the actual price is for the individual to still be better off buying the annuity. I would actually say that Tony Webb has done some work in that regard in the sense that, you know, his models and simulations show that – and Olivia Mitchell – that even with some adverse selection in pricing, that you could still have gains from annuitization. I don't know if that answered your question completely.

Q: Well, I assume that as more people buy annuities, that eventually, the actual experience of the own mortality (ph) becomes more like conventional life expectancy. But I was – in terms of dispelling the concerns the consumer would have, at what point do you say, well, in fact, there has been a response by the industry and things are better than they were back in September, 2009?

MS. WALKER: Yeah, actually, so I just want to mention the experience in the U.K. In the U.K. there's a larger annuity market, and if you look at the experience of the U.K. annuity providers, you find that actually, pricing in the U.K. annuities are lower than they are in the U.S. and it's because some of that adverse selection has been removed, but not completely.

So if you look at the mortality experience of annuitants, they don't exactly match the population mortality because not everybody in the U.K. are buying annuities through the mandate. But that would be one way of assessing – if you look at the mortality experience of the annuitants.

MR. MACKENZIE: I just wanted to say that, strictly speaking, actuarially fair or unfair is not, I think, the appropriate criterion because there is no financial product or no insurance product that's not actuarially unfair because even the most efficient insurance company has costs, which are not reckoned in these calculations. But in principle, I guess what you'd have to do is check out the life expectancies of insured people and compare them with non-insured people and, if they're converging, then you're making progress in that respect.

MS. PERUN: I'm a lawyer, not an economist or financial engineer, but I think our view of the – what we tried to do in our proposal was to constrain the age cohort that would be subject to annuitization every year on the theory that, that might help – we would have more data on people between age 62 and 66, for example, that would help with the pricing of annuities.

MS. MCCUBBIN: Yes, sir. And we have a microphone for you, if you could identify yourself.

Q: Sure, my name is Mark Nadelle (sp) from Georgetown University. I'm wondering does the case of "be careful what you wish for" – you know, imagine a world in which most Americans – retired Americans – now had annuities and you had the financial meltdown that we had. And this is just – there's probably a factual basis to exploit here. I'm wondering, for the companies, if the small annuity market now, how have insurance companies that offer these annuities coped?

If they have losses in the annuity market, presumably, they could easily make up those losses through their other lines of life and health, particularly, life business, but if annuities is a huge part of the market and they lack the resources, would they be looking at the necessity of a huge government bailout?

MS. MCCUBBIN: Does anyone want to talk about how insurance companies hedge their bets or how, for example an in-service annuity would have avoided some of the problems of trying to annuitize during a recession.

MR. MACKENZIE: I think that the risk would depend very much on the extent to which the insurance company financed – or funded, rather, it's annuities through corporate debt and equity, I suppose. If you funded the debt with your – funded your annuities through Treasury bonds, then I think the issue would be moot. And I don't – insurance companies, as I understand it, tend to fund life annuities through assets that have a similar duration. And to the extent that they do that, then I think that's less of a problem. On the other hand, I guess, if a huge increase in the spread between corporate bonds and Treasuries were to open up, that could spell trouble if they were invested.

MS. MCCUBBIN: Tony, did you want to add anything?

MR. WEBB: Yes, I wanted to say that one of the important risks that insurance companies face when they sell annuities is aggregate mortality risk – the risk that life expectancy increases more rapidly than forecasted by mortality tables. And there is an emerging market in mortality derivatives. And there's actually a conference on the subject in New York next Friday if you – (audio break.)

MS. PERUN: (Audio break) – on that very question right now. And I would hope that some enterprising economists, in 5 years, would look at what is happening now. I know there are many states that have relaxed capital requirements for insurance companies during this particular time, and we'll just have to wait and see if that's enough.

MS. MCCUBBIN: Another question? Well, let me ask one then. And I guess this will probably go to Lina and to Sandy. You've both noted that very few defined contribution plan sponsors offer an annuity option. And I'm wondering what the barriers are to getting employers to adopt these new features or any annuity into their defined contribution plans, and how those barriers might be overcome.

MS. WALKER: Well, one of my coauthors – Mark Iwry – actually was in Treasury a while ago when they made the decision to give employees the option to stop offering annuity as a distribution option. And his perspective was that, it seemed as if employers not – it seemed as if employees were not interested in the option and so employers chose not to carry that distribution option in 401(k) plans. So maybe one way around that would be if employees are asking for it – if there is a growing interest – because there is some way of addressing some of the annuity aversion, there might be a shift in the perception of whether or not it's something that the employees want.

I think there's a bigger, more fundamental question, as well, is that when you offer something like that through the employer plan, the plan sponsor – the employer – might be subject to some fiduciary liability, and so the question is, what sort of protections can you offer the employer so to encourage them and make them feel a little bit more at ease about offering something that is somewhat complicated, that is long-lived and potentially, you know, without proper safeguards, might be an issue.

And I think that – I would say that we thought a lot about it, but we didn't come up with – unfortunately, didn't come up with an answer to that question. But you know, there are examples. We have investment options in 401(k) plans, and there are those same issues of fiduciary liability; employers are ready and willing to offer them. You have the qualified default investment alternatives – that might be one way of offering protections to employers, but just do something similar for annuities. So that's what I can think of.

MR. MACKENZIE: I'll just add that, perhaps, Lina's trial period idea might work – that, perhaps, an employer would have a safe harbor if he offered, in effect, a temporary plan that the employee could always opt out of, and there would have to be other safeguards like adequate notice and so on. But certainly, the potential for liability, because at least, if you opt into or simply get a standard annuity, it's irrevocable, period. And you can come back and the employee can say I didn't understand this, you know, or why didn't you tell me to wait one more year, or whatever it is. These issues have to be resolved.

MS. MCCUBBIN: Pamela?

MS. PERUN: When I was practicing as an employee-benefits lawyer, I always told my clients not to put annuities in their plans, because the dilemma that – the decision tree is, if you just have lump sums, people take their money, they leave. There are no strings attached to you. If you put an annuity in your plan, you have like 3 to 6 years of exposure to fiduciary liability for the choice of the particular company that you put into your plan to offer these annuities.

And so you are, as an employer, actually guaranteeing the insurance company. And most of my clients refuse to put annuities into those plans. And I think that is the real issue – who is going to guarantee the annuities? And most employers do not want to be the backstop for an insurance company, even on a short-term basis.

MS. MCCUBBIN: We have a question or response from the back?

Q: Just had a question – not closely linked. I'm just curious what the panelists think about the cosmetics of having – I'll give a hypothetical – a university that offers annuities to its employees. Let's say you have your very white-collar professors and people who might be expected to have a lot of longevity ahead of them and you have the cleaning staff that might be expected to have less longevity.

How do you deal with the cosmetics of answering the question, well, this individual died 2 years after buying an annuity – isn't that terrible. And then the professors of English who lives to be 100 and gets every last dollar –

MS. MCCUBBIN: I think we'll let the academic answer the question. (Laughter.) But could you identify yourself as well?

Q: I'm Tom Kahlman (ph) with CFA Institute.

MS. MCCUBBIN: Thank you. And also panelists, I'm told that they can't hear us, so if you can just pull the microphone towards you, that would be great. And with that, I'll let Tony answer.

MR. WEBB: Yes, there is an academic literature on the subject. There's a paper by myself and a coauthor; there's a paper by Jeff Brown – and what the papers show is that the value of the longevity insurance provided by life annuities is such that it's valuable even to the low-life-expectancy worker – that even if you're a low-life-expectancy worker, you've got some risk of living to advanced, old age. At the risk of using academic jargon, in expected-utility terms, rather than in money's worth terms, there is not that much difference in the valuations that various types of workers ought to place on annuities.

Q: I've shared your experience with employers wanting to take out the annuity, if at all possible, from the 401(k), and god forbid putting it in. I think the concern a lot of employers have is somehow, the existence of an annuity form within a 401(k) will allow the government to say ah, now we're going to infuse into the plan all of the complicated requirements that defined benefits plans have that are very difficult for the average mortal to deal with, such as explaining what the relative benefits are of each alternative form of benefit payment.

And so I wonder if there's been any thought to ensuring people that the proposals will not infuse into a 401(k) plan, which the employers can now manage relatively comfortably, a lot of complications that require outside actuaries and more attorney's fees and so forth, that have become necessary, the way the defined benefit plans have been regulated? Some attorneys that have done risk work for 30 years will not do defined benefit plans anymore because they've become so complicated to explain.

So it's the complications associated with surviving spouse – or rather, spousal waivers – as you say, the liability of the employer making the right choice, the, perhaps, need to explain what the relative value of every possible form of benefit payment is – these complications. If the employers could be led through this gently, you know, I think there, indeed, could be a lot more receptivity to the concept of having a trial go at having annuities be part of these programs.

MR. WALKER: Okay I'll lean forward. (Chuckles.) Thank you very much, Bill. You know, I think that it's true that there potentially could be a lot of complications by offering our trial-income plan through the employer, but I just want to re-emphasize why we think that the employer approach is a good approach. If behavioral bias is, indeed, a real obstacle to buying the annuity, having people cash out their 401(k) plans and then take that to whatever provider, or some other platform to buy the annuity, is a big step.

And we wouldn't expect individuals to take-up the annuity if we were to let them – in some ways, it's almost business as usual; they still have to go through the additional steps before they can buy the annuity. And we take this notion of behavioral obstacles very seriously. We want to make it as easy, as simple as possible for individuals to annuitize part of their retirement assets. And the employer plan is the obvious platform to do it.

Now, if we had a simple solution for it, I think that this plan would have been implemented a long time ago. But you're right. It is a complicated issue. We don't want to over-burden employer plans to the point where they don't want to offer 401(k) plans. But I think that it is possible to sit down and, as you say, think about some way of simplifying the process. Don't burden them with onerous regulations and reporting requirements. Talk through it with as many stakeholders as possible and I think it's possible to generate a plausible and workable solution.

MS. MCCUBBIN: I'll let Pamela respond and then we'll take a question here.

MS. PERUN: In our work at IFS, we are particularly concerned with low and moderate-income Americans and we see a big coverage gap in the 401(k) plans, and we're afraid that if all of our efforts go toward encouraging annuitization through that vehicle, that we are losing a whole swath of Americans, because 401(k) plans largely serve large-to-medium-sized employers; there are vast numbers of Americans who are not even in the employer system and we think that they deserve a fair shake at getting a way to transform whatever savings they have into income that lasts a lifetime, and that's why we choose a more universal vehicle, which is the Social Security system.

Q: (Inaudible, off mike) – from the Senate aging committee. The speaker brought up the issue of joint and survivor annuities and I hadn't heard that discussed at all. How would your programs work for couples so that you could ensure that both members would have a lifetime income?

MS. PERUN: I think in our proposal, we would have the first choice be a joint and survivor annuity proposal, but – and I think, politically speaking, you would have to have spousal consent. So that adds another wrinkle to the program, but I think in terms of equity, that it basically the policy outcome.

MS. WALKER: During the trial-income period, it would be just the straight, single life annuity. But in our proposal, we do recommend that when the trial annuity gets defaulted into a permanent income plan or annuity plan, that it is a joint and survivor annuity.

Q: Thank you. I'm Kathleen McNally from McNally & Associates. And I have two questions: One is, have any of you looked at the TIAA-CREF data, which, it seems to me, would give you a ready-made database to look at decisions about investing in the stock market versus annuities?

And the other is, given the prevalence of high divorce rates in our country, has any of you looked at your models, especially in terms of spouses receiving benefits if they've been married

more than 10 years and are divorced, and how that might affect some of your conclusions, especially with regard to spousal consent, which is a very touchy subject if the spouse is someone from whom you've been divorced.

And in just – I was struck by your surfing the Web to look at what's out there – I've seen more and more Web sites that counsel women, if you've been married 9 years and you're thinking about a divorce, hold on for that 10th year. (Laughter.) I've seen this several times. Thank you.

MS. MCCUBBIN: I think there were two questions in there. Does anyone want to speak to the data or the –

MR. WEBB: I can make a comment on the first question. I thought the second question was extremely interesting; I'm not sure I know what the answer is. I think it's, maybe, a false choice to argue that people have to choose between, on the one hand, purchasing an annuity, and on the other hand, investing in the stock market – that both bonds and stocks can be held in both annuitized and unannuitized form, and that what households really need to do is to separate the annuitization from the investment allocation decision.

If you want to have exposure to the stock market and you want to annuitize, then the right product for you is a variable immediate annuity. If, on the other hand, you want to have longevity insurance and don't want to be exposed to the stock market, then the right produce for you is a fixed annuity.

MS. MCCUBBIN: Pamela, did you –

MS. PERUN: On the TIAA-CREF data, I believe John Amarix (ph) and others have looked at the experience of people choosing annuities there and it's no better.

MS. MCCUBBIN: John?

Q: Hi, I'm John Stablehouse (ph). I'd like to try and gauge the extent of your beliefs about market failure by making this personal. And all I want is from all four of you is one number. So every one of you is ready to retire and after a career of good public service, you're entitled to \$30,000 a year in Social Security benefits.

You also have a million dollars in your DC account – and based on Tony's numbers, that would generate an annuity of \$50,000 a year, or you annuitize, you get five cents on the dollar. The one number I want: What fraction of that million dollars do you choose to annuitize and what fraction would you keep in the bank? One number.

MS. WALKER: Sorry, John. I can't give you one number.

Q: No, you have to give me one number!

MS. WALKER: (Chuckles.) No, sorry!

MR. MACKENZIE: I would say with \$30,000 had a present value of about 600 – let's see – yeah, 600, right? Fifty times 20 is a million and –

Q: That's about the benefit for a max. earner right now, which is what, sort of our projected cohort. You have a million dollars –

(Cross talk.)

MR. MACKENZIE: Your annuitized wealth from Social Security is already \$600,000; you have an additional million of unannuitized wealth. It's reasonable to me that people would want to annuitize some, \$200,000 or \$300,000 of the million, and perhaps keep the rest.

Q: All right. I've got one number; I need three more. I'm serious! This is what you're telling the world to do; Tony, you've got to give us a number.

MR. WEBB: Off the top of my head, I – (inaudible, laughter). I mean, John is making a very serious point, I think, that is, if you look at what academic economists say people ought to be doing, there's probably a big disconnect between what academic economists say is good for people and what academic economists themselves do. (Laughter.) It's a serious and valid point. I'm not certain I can answer it. I'm not in that situation. I love my job so much that I'm planning on working forever. (Laughter.)

MS. MCCUBBIN: I have, actually, two follow-up questions on that. One is, Lina, what fraction did you assume would be annuitized of the 401(k) wealth in the trial period?

MS. WALKER: We actually didn't propose a particular fraction. So we left that as something open-ended that we wanted to explore a little bit further. Now, what we did say was that it probably would be a substantial amount and it might be anywhere between a third to as high as 75 percent, but a lot of it would depend on the situation of the annuitant and whether or not they had a high replacement rate from Social Security, whether they had other forms of annuitization – say, from a DB pension – whether they're married and, so, could engage in some risk-sharing in the marriage.

But what we believe is that it well could be a large amount – (audio break). So I think that there is, as Tony says, there is sort of – it's one thing to – (inaudible) – but it might not be the right thing to do in our current environment. So for instance – (inaudible) – options, it's really off the table. So from that perspective, we're trying to pick around what portion would be a reasonable proportion of the – (inaudible) – to annuitize – (inaudible) – some payment with a – (inaudible).

MS. PERUN: I would sink my \$100,000 into my starter annuity – such a convenient – and then I would keep the rest out –

Q: So you're going to get \$500 – no, \$5,000 from that.

MS. PERUN: And the reason we chose the \$100,000 figure is that – (inaudible).

Q: But that's one – just to put it in perspective – that's one-tenth of the – (inaudible).

MS. MCCUBBIN: Now, Tony had explained the delaying claiming your Social Security is one of the cheapest ways to – (inaudible) – forever. (Laughter.) But Pamela, I was wondering if you might comment on Tony's suggestions for encouraging workers to delay claiming Social Security benefits in order to sort of increase the share of wealth that is annuitized? And if we could do this, would we still need – (inaudible)?

MS. PERUN: Well, I think we absolutely need to – (inaudible) – Social Security benefits. I would say, though, that in a conversation with – (inaudible) – Social Security Web site – (inaudible). I think that – (inaudible).

MS. MCCUBBIN: Anyone have questions? Carlos?

Q: Carlos Vivia (ph), PPI. I have a question for Pamela. I would really like to – (inaudible) – the rationale for the \$100,000 of debt?

MS. PERUN: Well, we picked that one out of the air, actually, because we are targeting the middle and lower-income Americans who would maybe not have – (inaudible). (Inaudible.) It's a relatively big scale.

MS. MCCUBBIN: Any of the panelists have any final comments?

MS. WALKER: Actually, I do have a question for Pamela. It's just a follow-up from your last comment. You said that your employees – (inaudible) – \$100,000 because that was – (inaudible). I guess my question to you is, you know, from a – (inaudible) – perspective, we felt that low-income – (inaudible) – that perhaps additional – (inaudible). But your perspective is slightly different and I'm just wondering what would be your rationale.

MS. PERUN: I think you make a very good point about the situation today, but we are hoping for – (inaudible) – is that we will all – (inaudible) – they will get an opportunity to increase their ability to – (inaudible). And the other thing that we've done is – (inaudible). (Inaudible.) So I think you're right about the situation today, but we hope it will possibly – (inaudible) – negative factors that are – (inaudible).

MS. MCCUBBIN: Thank you, panelists, and thank you all for attending. I hope this has given you all some proposals to chew on, on how we can help retire – (inaudible) – in and around retirement. And I just want to draw your attention to, next Monday, we will be having an event, "What Happened to my Social Security Cola?" – (laughter) – and that will be about the same time next Monday in the Columbus Club in Union Station. There's an invitation in your packet and you can also find out more at aarp.org/ppi. So if you want to attend – (inaudible). Thank you – (inaudible, applause.)

(END)