Personal “draw-down” pensions in the US

Frank Todisco, FSA, MAAA, EA
American Academy of Actuaries
todisco@actuary.org

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Outline

1. Framing the problem

2. **Sources** of longevity insurance gaps in US

3. **Causes** of these gaps

4. Potential solutions / policy initiatives

1. Framing the problem

Framing the problem:

1. Absence of longevity insurance

2. Other aspects of sound “draw-down” management
    - Amount and timing of spending
    - Asset allocation and selection

Focus on the longevity insurance aspect of the problem

- Efficiency: Costs much more to self-insure longevity risk than to pool it
  - Inefficiencies exceed 30%, depending on how measured
- Securing longevity insurance often automatically assists in managing spending and investment risk
- **The best solution to managing personal "draw-down" pensions is to avoid them in the first place**
  - **Reduce their incidence and proportion**
  - **More longevity insurance**

2. **Sources** of longevity insurance gaps in the US

Longevity insurance gaps in US

Context: "7-legged stool" of retirement security:

1. Social Security
2. DB plans
3. DC plans and personal savings

4. Medical and long-term care insurance
5. Housing wealth
6. Continued (part-time) employment
7. Cost-sharing, family, community

Medical and long-term care insurance

- Possibility of catastrophic health event creates need for liquidity

- Liquidity concerns trump annuitization

Social Security

- Very high proportion commence retirement benefits at earliest eligibility (age 62)
  - Approx. 76% benefit reduction vs. commencing at age 70
  - In 2006, 46% of workers claimed benefits as soon as they became eligible (Source: *Are People Claiming Social Security Benefits Later?* Muldoon and Kopcke, Center for Retirement Research at Boston College, 2008)
  - Deferring commencement is equivalent to converting more of your retirement wealth into longevity insurance

Defined benefit plans

- Long decline in DB coverage over several decades
- For plans that remain, more lump sums
  - Cash balance plans
  - Traditional plans that added lump sum options

Defined contribution plans

- Massive shift from DB to DC in private sector
  - Typically no annuity option

The DB/DC Evolution

For private sector workers with pension coverage, type of plan:

Year	DB only	DC only	Both
1983	62%	12%	26%
1995	29%	56%	15%
2007	17%	63%	19%

Source: Center for Retirement Research, An Update on 401(k) plans: Insights from the 2007 SCF, March 2009. Last row doesn't add to 100% due to rounding.

Notes:

- 55% of private sector full-time employees have pension coverage.
- DB plans are widely used in public sector and for multi-employer plans (union/management sponsored).

3. **Causes** of longevity insurance gaps

Liquidity needs due to potential health costs

- Relatively less pooling of health care risks than in other developed economies

Age 62 commencement of Social Security benefits

- Over past few decades, consistent with earlier retirements generally
- In more recent years, exaggerated fears that program will completely disappear
- Current recession
- Lack of understanding of longevity risk

Decline of DB, shifts to DC, shifts in types of DB plans and options

- Complex mix of potential factors
  - At least a dozen explanatory factors have been offered or asserted for decline of DB

Obstacles to availability

- Why DC sponsors don't include annuity options

- Annuity market inefficiencies
  - Complexity/transparency problems?
  - Health of insurer, variation in state guarantees

Obstacles to usage

- Lack of financial literacy
- Behavioral finance

4. Potential solutions / Policy initiatives

Age 62 commencement of Social Security benefits

- High prevalence drawing attention

- Interest in Congress in revising annual Social Security benefit statements

Long-term decline of DB

- Support for DB in current administration
  - But how to channel it is far from clear

Lump sum, annuity options in DB, DC

- Mandate annuity option in DC?
- Tax break for distributions taken as annuity (2009 legislative proposal, but for DC only)
- Restrict LS options in DB?

Financial literacy

- On everyone's radar, including initiatives by Administration, Actuarial Foundation
- Longevity risk not understood
- Retirement planning software typically uses life expectancy and *masks risk* (Society of Actuaries finding)

Behavioral finance proposals

- Frame as “guaranteed lifetime income” rather than “annuity”
- Present benefits in lifetime income form rather than lump sum form; or provide “lifetime income equivalent” of single sum accruals (legislative proposal)

- Annuity as default option
- “Test-drive” annuity -- default trial annuity for first two years of retirement

Federal government Request for Information (RFI)

- How to facilitate access to, and use of, lifetime income arrangements
  - 39 questions

- Comments due May 3 (American Academy of Actuaries drafting response)

RFI on lifetime income arrangements

- Includes queries regarding
  - Expressing single sums as lifetime income equivalents, and how to do so
  - Mandating lifetime income options, or making default option
  - Partial annuities
  - Trial annuities
  - Deeply deferred annuities
  - Incrementally earning annuities during accumulation phase
- Many of these ideas could be applied to DB as well as DC

Initiatives not involving annuitization

- Proposals to regulate:
  - Target date funds
  - Fee disclosure
  - Investment advice

Questions?