401K Follies: A Proposal to Reinvigorate the United States Annuity Market

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Introduction

One does not need to do anything but look around to see that the United States population is aging at an alarming pace. With the aging of America, more emphasis has been placed on retirement security. The three-legged stool of retirement security – personal savings, Social Security, and private pension accounts – is increasingly dependent on the private pension leg. This is because personal savings rates in the United States are near or at an all-time low, and Social Security, even if we assume it will remain solvent, merely provides a fraction of what most people need to live comfortably in retirement.

In the private pension world, the United States has recently emerged from a troubling move away from defined benefit plans (DBPs) (i.e., traditional pensions) to various forms of defined contribution plans (DCPs). Because employers are responsible for providing a defined benefit amount to employees at retirement under DBP arrangements, there is more regulation of these plans to ensure that the promised benefits are available upon retirement and plans do not default on their pension promises. For instance, the Employee Retirement Income Security Act of 1974 provides for minimum vesting, benefit accrual, and funding standards for DBPs and sets up an insurance scheme, operated by the Pension Benefit Guaranty Corporation in case of employer defaults.

On the other hand, employers are only responsible to contribute money to their employees' individual plan accounts under the DCP model and that is where their responsibility ends. Although DBPs historically were the retirement plan of choice, there has been a significant shift to DCPs by employers in recent years; DCPs generally cost less, place fewer obligations on the employer, and are portable from one employer to the next. For instance, from 1979 to 2001, the number of DBPs went from 139,489 to 51,000, while the number of DCPs went from 331,432 to 707,000.

Potential Problems for Retirees

This trend is troubling. Whereas the employer was responsible for providing the pension benefit to the employee upon retirement under DBPs, DCPs only require the employer to a pay a defined amount into an employee's individual account. At that point, it is up to

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the employee to invest the pension funds in various financial instruments so that he or she will have sufficient funds available to last through retirement. DCPs thereby place the risks of longevity, investment return, inflation, and interest rates, on the employee. Consequently, no guarantee exists that a participant will receive any specified amount of benefit at retirement and many baby boomers are waking up to this strange new world of being in charge of their future retirement.

The problem is exacerbated because most individuals with DCPs now find themselves enrolled in a 401K plan. Under a 401K salary deferral plan, which may include an employer matching contribution component, the employee directs the employer to divert a specified percentage of his or her salary into his or her retirement account rather than receiving it as cash compensation. The employer matching contribution provides incentive for employees to contribute greater amounts to these individual accounts. The Pension Protection Act of 2006 provides an additional mechanism for encouraging employees to save for retirement by permitting qualified automatic enrollment features. Such contributions, like other retirement plan contributions, provide the advantage of tax deferral for the employee, and tax is not paid on this income until such funds are distributed from the account.

Although one of the advantages of the DCP is that it is portable from employer to employer in our mobile economy, many disadvantages exist as well. Chief among these is the problem of "pre-retirement leakage." Pre-retirement leakage occurs when an individual takes money out of the plan for qualified or unqualified reasons before reaching the minimum retirement age of 59½ years. Qualified reasons include hardship distributions for education or home purchases, and some 401K plans are also set up to provide qualified plan loans. Individuals also take money out of their 401K for unqualified reasons that lead to the double whammy of paying a 10% excise tax plus having the plan administrator withhold 20% of the distribution amount for federal income taxes. Treas. Reg. 1.402(c)-2, Q&A-1(b)(3). The expense of premature withdrawals is even worse when one considers the time value of money. Money withdrawn may be, of course, invested, but that money is no longer able to grow tax-free.

Part of what makes DCPs easy for employers is part of the problem that make them so dangerous to current and future retirees. Because employees can see their pension money in individual retirement accounts, they have a false sense of security of having an extra pot of money to pay off expenses in the here and now. Unlike traditional pension plans, which could not be accessed until retirement age, 401K plans permit access which leads to bad retirement planning practices by many individuals. Many do not keep their money in these accounts until retirement. Even when they do wait, they take their distributions at retirement age in a lump sum. And rather than roll these amounts over into an IRA for further tax-deferred growth (at least until the required minimum distribution rules kick in), they place their investment money into normal investment and savings accounts. Not surprisingly, they are not doing a very good job of self-annuitizing; that is, providing an income stream for themselves for the rest of their lives. Indeed, it is not unusual in these days of the 401K to hear about older individuals not retiring at all, un-retiring, or working a second job as a grocery store bagger – not outcomes they envisioned doing in their golden years.

Proposals for Change

Part of the solution to this growing retirement security problem is to require 401K plans to offer an annuity option in addition to the normal lump sum distribution. Although some 401K plans now provide for such an option, most currently do not. Unfortunately, many employees do not adequately understand the purpose of annuities and dismiss them as high-priced retirement luxuries. Yet, the Employee Benefit Security Administration is in the process of reexamining a role for annuities; a recent call for comments on how employers may be able to provide lifetime income options to their retirees received over seven hundred comments.

The annuity option permits individuals to purchase an insurance contract through their employer that will provide guaranteed income to them for the rest of their lives. This idea of attaching an annuity option to DCP plans derives in part from the United Kingdom, where DCP plans are becoming just as popular as in the United States. In the United Kingdom, an annuity must be purchased with at least 75% of an individual's pension sometime between retirement and age 75. Although I think instituting mandatory annuities in this country is probably a non-starter given our well-known aversion to any government plan infused with "socialism," I propose requiring annuities be one required distribution option for 401K participants. For reasons discussed below, I would also require employee education, pre-distribution, on the advantages of having an annuity over taking a lump sum, and require insurers to adequately disclose fees for their annuity products.

This annuity proposal is by no means fool proof. Many issues lurk just around the corner, including the lack of an adequate annuity market in the United States. The lack of an annuity market is tied to the relative expense of offering such annuities, as well as the illiquid nature of such investments (which means loss of control over income). In the United Kingdom, where retirement account holders must hold a certain percentage of their portfolio in annuities in retirement, the annuities market is more robust. Requiring annuities as a 401K distribution option may be the first step in overcoming the lack of an adequately competitive American insurance market. Additionally, I would suggest another innovation from Britain. Since 1978, defined contribution plan members in the UK have an open market option (OMO) for buying their annuities from a supplier other than their pension provider. Having 401K participants "shop around" for their annuities will likely generate downward pressures on the price of annuities. Finally, under this proposal, more employees will be likely able to afford annuities through their employers or under the OMO at institutional pricing rather than through retail pricing.

The education part of my proposal recognizes that annuity products are very complex and, consequently, insurers are able to charge exorbitant fees for them. Their complexity also makes employees less likely to select them. Additionally, there is no current requirement to disclose the fees charged with the annuity option. This last shortcoming can be addressed by requiring fee disclosures for annuities similar to what will be required of 401K service providers under new Department of Labor fee disclosure rules. However, to be fair, not all the problems with annuities rest on insurer shoulders as it is difficult to price an insurance product when the data needed to make a reasonable calculation is not known. Of course, a defunct insurance company which charges too little for annuity products would do no one any good.

Conclusion

Even given potential issues with requiring an annuity option for 401K plans, the time has come to hedge as a society against the risk associated with the recent embrace of the 401K as the private retirement funding vehicle of choice in the United States. The proposal described herein seeks to diminish the retirement security deficit through three interlocking regulatory parts: (1) a requirement to offer an annuity as part of 401K distribution options; (2) mandatory education pre-distribution on annuities; and (3) mandatory fee disclosure by annuity providers. These steps will likely reinvigorate the annuities market in the United States and help to bring an end to the 401K Follies.