RETIREMENT INCOME INSTITUTE
Alliance for Lifetime Income

CONSIDERATIONS FOR INCLUDING AN ANNUITY IN DEFINED CONTRIBUTION PLANS

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While annuities are still relatively rare[1] in 401(k) plans today, interest among the defined contribution (DC) plan community in strategies that provide protected lifetime income appears to be increasing. In this piece, I summarize the key points of a paper[2] recently published through the Retirement Income Institute of the Alliance for Lifetime Income, which explore key considerations for plan sponsors who are deciding whether to include an annuity in a DC plan.

Overall, I find that the notably different product (and benefit) structures and varied preferences among plan sponsors make it unlikely that there is (or will be) a single product or strategy that is truly optimal for all DC plans. However, there can be significant benefits to participants who have access to institutionally-priced, high-quality annuities. Therefore, plan sponsors should actively consider strategies that work best given their objectives for the DC plan and their participants.

STRATEGIES REVIEWED

The strategies reviewed in the research include the following:

Single Premium Immediate Annuity (SPIA): fixed guaranteed lifetime income that commences immediately, typically irrevocable.

Deferred Income Annuity (DIA): fixed guaranteed lifetime income that commences at some point in the future, typically irrevocable. Also referred to as "longevity insurance" if the income benefit commences later in retirement and can be a "Qualified Longevity Annuity Contract" (QLAC) if certain provisions are met.

Guaranteed Lifetime Withdrawal Benefit (GLWB): guarantees some minimum level of lifetime income even if the underlying account value goes to zero. Typically, some access to contract value (i.e., revocable). Offered on both fixed annuities (FAs) and variable (VAs), which are covered separately in this piece.

Protected Lifetime Income Benefit (PLIB): provides a "protected" income amount that evolves during the payout phase based entirely on returns of the account even if the underlying account value goes to zero. Typically offers access to contract value (i.e., revocable).

Delayed Claiming of Social Security (SS) Retirement Benefits: using savings to fund spending earlier in retirement to increase SS benefits.

1. https://www.pionline.com/defined-contribution/annuities-struggle-foothold-401ks-despite-being-mainstay-403b-plans
2. https://www.protectedincome.org/research/selection-considerations-for-plan-sponsors-when-including-an-annuity-in-a-defined-contribution-plan/

KEY THOUGHTS

Determining the appropriate spending rate from savings is highly difficult given uncertain markets and by idiosyncratic longevity risk. While efficient portfolios should improve the probability of funding a retirement goal, portfolios cannot typically explicitly address longevity risk, which is why longevity protected solutions, such as annuities, are attractive to certain retiree households. Annuities, like all forms of insurance, are not necessarily wealth maximizing, although the "costs" associated with an annuity is going to vary depending on how the retiree values the trade-off between lifetime income and any kind of residual benefit at death (as well as the certainty around the benefit).

One potential benefit to purchasing an annuity inside a DC plan is higher payouts resulting from the favorable institutional pricing. There can be significant distribution costs with annuities, in particular the sales commission, that vary by product and reduce the final expected income received by an annuitant. By offering annuities inside a DC plan, it may be possible to increase the effective payouts given things like reduced distribution costs and economies of scale, although the expected benefit is going to vary by product.

Annuity payouts from a DC plan must be calculated on a gender-neutral basis (because the Supreme Court previously ruled that using gender-based mortality tables would be discriminatory). This can have significant implications for products such as life-only DIAs (i.e., QLACs), but less of an issue for products that are revocable, including GLWBs and PLIBs, as well as products which include some type of period certain or cash refund provision.

Many companies are working on the administrative issues required to offer an annuity in a DC plan, including portability, a feature allowing participants to transfer the underlying benefits of the annuity to an IRA if the participant were to leave the DC plan (or if the plan changes recordkeepers). Fiduciary risk has been a notable hurdle although it has been addressed through recent legislation, in particular the SECURE Act.

Finally, DC plan sponsors are unlikely to have an accurate, complete perspective of participants' financial situations. This is important when attempting to determine things like the potential value of allocating to an annuity or selecting the optimal annuity for a plan (given the lack of complete) information.

DEFINING "OPTIMAL"

Research on annuitization has largely focused on the economic benefits of a given strategy (e.g., should the retiree annuitize), which ignores the general preferences of retirees and the actual product landscape. In reality, there are a variety of domains that could affect the definition of a truly "optimal" annuity, such as behavioral considerations, the product landscape, and economic efficiency.

It is unlikely a single product could be considered optimal across all three domains. For example, while DIAs are often described as the most economically efficient annuity (especially by retirement academics), there are a significant number of product and behavioral considerations that should be considered before selecting the product for a plan. For example, in research[3] I recently conducted with Branislav Nikolic, we demonstrate the relatively extreme variations in DIAs over time, especially among those with pronounced delay periods (e.g., 20 years).

These considerations are interconnected. For example, making a product more behaviorally attractive could actually increase the economic efficiency if it induces individuals who otherwise would not buy an annuity to do so. Products with GLWBs have annuitants who are notably less healthy (i.e., have higher mortality experience) than those who have purchased DIAs, which is going to affect the pricing of respective annuities.

While defaulting participants in a DC plan into any form of an annuity has the potential to reduce adverse selection effects, something I've explored[4] previously with Michael Finke, the decision to annuitize (i.e., turn the monies into income) is typically up to the participant in many structures. Therefore, while adverse selection effects may be reduced by including an annuity as part of the default investment, they nevertheless remain, which has important implications on pricing (or relative value).

The following exhibit summarizes some of the key differences between the various annuitization options available to plan sponsors across these three dimensions for the five annuities considered, in addition to delayed claiming of Social Security benefits.

3. https://onlinelibrary.wiley.com/doi/abs/10.1111/rmir.12244
4. https://www.protectedincome.org/wp-content/uploads/2022/08/RP-12_Blanchett-Finke_v3.pdf

Attractiveness Across Dimensions, Specific Factors

Behavioral	**Delay SS**	**SPIA**	**DIA**	**FA+GLWB**	**VA+GLWB**	**PLIB**
Ease of Understanding	High	High	High	Medium	Low	Medium
Existing Participant Interest	Medium	Medium	Low	Medium	High	High
Control After Annuitization	Low	Low	Low	High	High	High
Economic	**Delay SS**	**SPIA**	**DIA**	**FA+GLWB**	**VA+GLWB**	**PLIB**
Benefit Stability	High	High	Medium	High	High	Low
Economic Value, Average Retiree	High	Medium	Low	Medium	Low	Medium
Residual Value, Early Death	Low	High	High	High	High	High
Product	**Delay SS**	**SPIA**	**DIA**	**FA+GLWB**	**VA+GLWB**	**PLIB**
Liquidity (Before Income Begins)	High	High	High	High	Medium	High
Liquidity (After Income Begins)	Low	Low	Low	High	High	High
Cost Transparency	High	High	High	Medium	Low	Medium

High   Medium   Low

Source: *Blanchett, David. "Selection Considerations for Plan Sponsors When Including an Annuity in a Defined Contribution Plan." Retirement Income Institute Research Paper, June 2003.*

The grades in the above exhibit are somewhat subjective and are based on the current pricing environment (which could obviously change). For example, SPIAs and DIAs are graded as relatively attractive from a cost transparency perspective versus a VA+GLWB which receives the lowest score. This is based on the simplicity associated with determining the quality of the expected income benefits. With a SPIA the payout rates from the providers can easily be compared. Alternatively, payout rates from a VA+GLWB are only one part of the product, which need to be assessed in their entirety. Regardless, while some strategies are likely to be better for retirees, on average (e.g., delayed claiming of Social Security retirement benefits), it is unlikely there could ever be one single strategy that is truly the best for every plan or participant out there.

CONCLUSIONS

While DC plan sponsors are increasingly focused on keeping participants in the plan post-retirement, there are a variety of perspectives on what it takes to make a DC plan retirement friendly. Annuities or other products that provide protected income are under increasing consideration by plan sponsors to simplify the process for generating income in retirement for participants, while explicitly protecting retirees from longevity risk. While it is unlikely that there will be a single product or strategy that is going to work for all DC plans, actively considering annuities and understanding the landscape is an important first step for plan sponsors interested in helping participants achieve a more successful retirement.