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Income As The Outcome: Reframing The 401(k) Plan

When the 401(k) plan was created approximately 35 years ago, it was envisioned as a supplemental savings plan rather than as a retirement plan. What is the difference? In a word: "income."

The defined benefit (DB) pension plans of yesteryear provided guaranteed lifelong income, much in the same way that the Social Security system does. In contrast, fewer than one in five 401(k) plans offer participants an opportunity to convert their accounts into guaranteed lifelong income.

That is a shame.

After all, why do we save for retirement? Is the sole purpose to find satisfaction in the size of our account at age 65? Of course not.

The reason most of us save is so that we can afford to maintain our living standard after we retire. This requires that we be able to afford the goods and services we that we rely upon, and to do so whether we live to 80, 90, 100 or beyond.

Financial planning for retirement is complicated because most of us do not know how long we are going to live. Consume too conservatively, and you miss opportunities to enjoy your retirement. Consume too aggressively, and you risk outliving your nest egg.

Annuities and other guaranteed lifetime income products can solve this problem. When you buy guaranteed lifetime income, the annuity provider – typically an insurance company – pools your assets with that of other annuitants. The assets of those annuitants who die earlier-than-expected are used to support the spending of those annuitants who die later-than-expected. This allows the insurer to pay you a higher level of income than you could provide for on your own. And the income will last as long as you live. Despite the fact that this concept has been around for thousands of years, we have built a private U.S. retirement system that fails to place guaranteed income at the center of the retirement discussion.

How did we get here?

Part of the answer is that regulators scared 401(k) plan sponsors away from offering annuities. For the first three decades of the 401(k) plan's existence, plan sponsors were lead to believe they were subject to an impossibly high fiduciary standard: that if they were to provide an annuity, it had to be the "safest annuity available." This created a perverse situation in which plan sponsors who provided employees with an annuity lived in fear of being sued.

Meanwhile, plan sponsors who left employees to fend for themselves were given a free pass.

By the time the Department of Labor clarified in 2008 that the "safest available" provision applied only to DB plans, the damage was done. Most 401(k) plans were built without any options for guaranteeing income for life.

The Department of Labor needs to establish a clear safe harbor so that employers who want to "do the right thing" can offer in-plan annuity options without fear of tripping over fiduciary rules.

But fixing the employer side is only part of the solution. The other problem is that we have conditioned 401(k) participants to shun annuities. Nearly every aspect of our 401(k) system – from rules governing minimum distributions to how we design account statements – has taught participants to measure their success in retirement planning by looking at their account balance. We should have been teaching them to think about how much income their 401(k) would provide them each month after they retire.

This "narrow framing" of retirement planning as being about account balances has a meaningful impact on attitudes and behaviors. In research published in a leading economics journal, my co-authors and I show that framing the retirement decision in terms of investment-oriented language that emphasizes account balances has the effect of biasing individuals against annuities. This is because when annuities are viewed as an investment, they appear risky.

After all, viewed in this narrow way, your rate-of-return depends on how long you live.

In contrast, when annuities are viewed through the lens focused on the more important question of how to maintain your living standard for the rest of your life, annuities look like an extremely valuable form of insurance. This is because no matter how long you live, you cannot outlive the income from a life annuity.

This framing effect is powerful: when an annuity is compared to a savings account using investment-oriented language, only about 20 percent of respondents report that the life annuity is preferred to the savings account. When the same information is presented in a consumption frame, the fraction preferring the annuity jumps to approximately 70 percent. Thus, nearly half the population changes their views about the relative desirability of a life annuity and a savings account based upon simple changes in how the products are described, even though the information content is unchanged.

Again, policy changes could help. Last May, the Department of Labor issued an advance notice of proposed rulemaking that would require plan sponsors to report how much lifetime income can be produced by a participant's 401(k), rather than just how much money is in the account on a given day. This is a positive step forward changing the conversation.

Other steps are also needed. Regulation should more clearly allow Qualified Default Investment Alternatives (QDIAs) to include annuities. Minimum distribution rules should be modified to prioritize income provision to retirees over Congress' ability to collect revenue. And financial planning tools need to recognize that uncertainty about length-of-life is a risk that needs to be insured.

In short, it is time we improve the retirement system by reminding everyone – regulators, plan sponsors, and participants – that income is the outcome that matters most for retirement security.