Putting the Pension Back in 401(k) Plans: Optimal versus Default Longevity Income Annuities

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Most defined contribution pension plans pay benefits as lump sums, yet the US Treasury has recently encouraged firms to protect retirees from outliving their assets by converting a portion of their plan balances into longevity income annuities (LIA). These are deferred annuities which initiate payouts not later than age 85 and continue for life, and they provide an effective way to hedge systematic (individual) longevity risk for a relatively low price. Using a life cycle portfolio framework, we measure the welfare improvements from including LIAs in the menu of plan payout choices, accounting for mortality heterogeneity by education and sex. We find that introducing a longevity income annuity to the plan menu is attractive for most DC plan participants who optimally commit 8-15% of their plan balances at age 65 to a LIA that starts paying out at age 85. Optimal annuitization boosts welfare by 5-20% of average retirement plan accruals at age 66 (assuming average mortality rates), compared to not having access to the LIA. We also compare the optimal LIA allocation versus two default options that plan sponsors could implement. We conclude that an approach where a fixed fraction over a dollar threshold is invested in LIAs will be preferred by most to the status quo, while enhancing welfare for the majority of workers.

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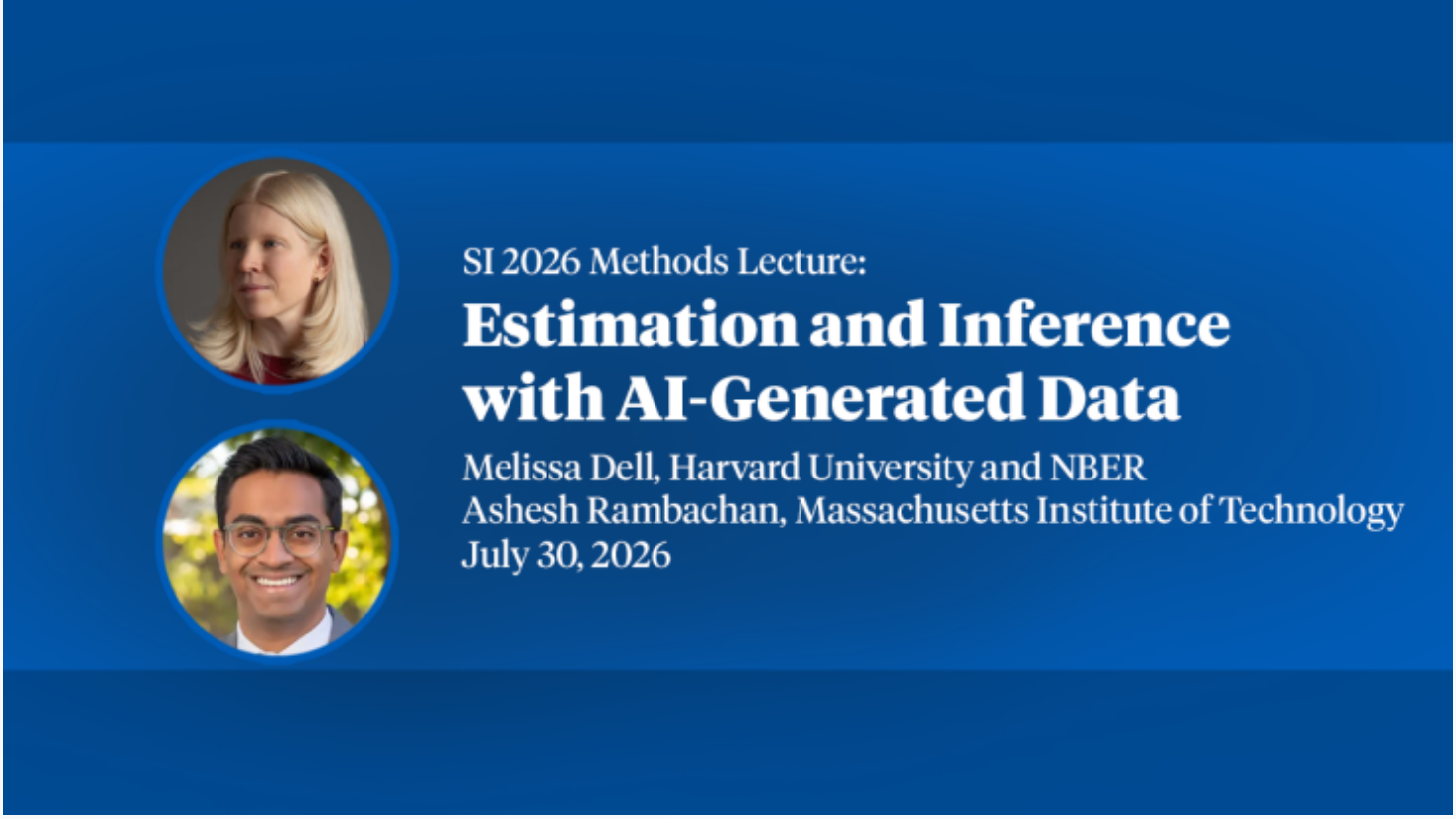


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