Is Your 401(k) Plan's Decumulation Default Faulty? An In-Plan, Autodecumulation Solution to Consider

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In London, when you board the tube (the subway), signs caution riders to "Mind the Gap" between the train and platform. So it is with decumulation decisions. Participants need to mind the gap between their anticipated regular expenses in retirement and their guaranteed, inflation-indexed retirement income.

Most U.S. workers stop working by age 65. Most claim Social Security (SS) benefits immediately upon retirement, failing to maximize the monthly, guaranteed, inflation-indexed income that SS offers. Most end up with a larger-than-necessary gap between regular expenses and guaranteed, inflation-indexed retirement income because the optimal claiming date for SS benefits (where the present value is maximized) is typically at/after full retirement age (FRA), which is age 67 for all born after 1959. SS replaces only about a third of a median wage worker's income at FRA.

Every 401(k) plan has a default or automatic decumulation provision specifying the form of distribution. Perhaps to simplify administration or in anticipation of the unique, ever-changing diversity of participants, the typical default form is a lump sum for balances of less than $7,000, paid at separation. For larger balances, the default is typically a lump sum at either normal retirement age or the age at which participants must begin required minimum distributions (RMDs). That age is also referred to as the *required beginning date (RBD).*

However, lump-sum defaults are often suboptimal. A considerable percentage of participants spend the money on other things if they receive the distribution prior to retirement.[1] And most retirees are not financially sophisticated or capable of managing a lifetime of savings paid as a lump sum.

Yesterday: 401(k) and Decumulation

Forty years ago, in my last plan sponsor role, we removed the annuity purchase option from our 401(k) when the 1984 Retirement Equity Act (REACT) added compliance com-

AT A GLANCE

- Detailed preretirement planning should start at or before age 50 and should be updated annually. Updates should include estimates of Social Security (SS) benefits and spending needed to maintain the preretirement standard of living and identify savings gaps available as well as protections and strategies, such as continued employment beyond preferred retirement dates.
- Regardless of their age at retirement, most workers need more guaranteed, inflation-adjusted income than SS typically provides to maintain their preretirement standard of living.
- The author recommends that plan sponsors adopt an autodecumulation default of a level-income "bridge" for participants ages 62 to 70 in order to facilitate deferred claiming of SS benefits, replacing the typical lump-sum default form of payment.

plexity and uncertainty. That was easy—No one ever asked for quotes let alone purchased the annuity.

In 1985, our 401(k) did not offer installment payouts. Almost everyone immediately cashed out with a lump sum at or after separation. Many elected to pay the taxes on the distribution using ten-year forward tax averaging. Some rolled over assets to individual retirement accounts (IRAs).

Back then, despite ultrarich retirement benefits, data showed less than 8% of all our 401(k) participants "retired" from our organization—arbitrarily defined as separating at/after age 62 with 25 or more years of service, ceasing all employment and immediately commencing payout.

Worse, we prompted workers to commence SS benefits at age 62. We facilitated retirements prior to age 62 by incorporating a "Social Security level-income option" in our retirement plans. With this option, individuals could concentrate more retirement benefits prior to age 62 (creating a "bridge") so that income would remain level once SS benefits started at age 62.

Much has changed over the past 40 years, prompted by compliance with legislation such as the Tax Reform Act of 1986 and the Pension Protection Act of 2006. In my 401(k), effective January 1, 1989, we changed our default from a lump sum to annual installments that met the RMD rules. It has since been updated for changes to the RBD—from age 70½ to 72, now 73 and soon to be 75.

Along the way, we made changes to foster asset retention, asset aggregation and account consolidation, such that one in five participants, representing between $1 billion and $2 billion in assets, is a term-vested or retired participant.

Another change is the ever-increasing diversity of participant populations. Over the past seven decades, the median tenure of U.S. workers has consistently been less than five years—a 13% per year turnover rate. An employer of 1,000 with a 401(k) that offers automatic enrollment at hire would experience turnover of about 650 participants over a five-year period. Assuming an average age at hire of 30, even if turnover declines by half (to 6.5% per year), less than 3% of all participants will "retire" from the plan.

Today: Suboptimal Social Security Claiming

U.S. workers who stop working before or at age 62 tend to commence SS benefits at age 62. More than half of people in the U.S. claim SS prior to reaching FRA. Most claim early because they do not have sufficient savings to finance delayed claiming to bridge the gap in income yet leave a reasonable residual amount of assets to provide liquidity.

Today, more individuals work into older ages. Those who continue past age 62 also tend to commence SS immediately after separation, even if they do have sufficient savings to defer.

So, while the average age at retirement has increased from age 62 to 65, the average age of SS commencement has increased only two years, from age 63 to 65.[2]

When claiming SS benefits, many factor in an inexact estimate of "break even"—the age when cumulative benefits from delay exceed those of claiming early. AARP estimates a break-even age of 78 and 8 months if delaying from age 62 to age 67 and age 80 if delaying from age 62 to age 70.[3]

However, Social Security Administration (SSA) data suggests that the average mortality age is seven to nine years beyond those break-even ages—Many people live much longer.[4]

Certain forms of cognitive bias, including the following, may trigger underestimates of longevity, prompting many to claim SS benefits early.

- **Anchoring:** With known eligibility at age 62, SS represents a "bird in the hand."
- **Availability heuristic:** A family member who died prematurely may lead a participant to fear the same.
- **Avoidance:** Mortality is a difficult topic.
- **Innumeracy:** Early claiming at age 62 appears more valuable instead of forgoing the first 60 (to age 67) or 96 (to age 70) payments.
- **Status quo:** A previously planned early retirement is difficult to change.
- **Temporal discounting:** Participants may attach excessive value to current payments and severely discount future payments.

Finally, claiming decisions may be impacted by a pessimism bias coupled with loss aversion. Participants may have a bleak view of their own health and longevity, as well as the financial sustainability of the SS system, including potential reductions in SS benefits. Each annual report from the Social Security Board of Trustees reinforces the concern that by 2033 or so, the trust fund will be exhausted and a 23% reduction in scheduled benefits will be required.

Most observers expect that any changes to the structure of SS will apply only prospectively and reduce benefits only for future retirees. If so, until Congress announces/implements changes, deferred SS claiming offers a unique enhancement to lifetime income.[5]

No In-Plan Insured/Guaranteed Income Option Could Be Ideal for All

One study confirmed that decumulation decision making should be five-dimensional, where the optimal product for any individual participant would vary with each person's unique needs, wants and priorities. The five dimensions include the following.[6]

1. **Longevity risk hedge:** Portfolio duration/planning horizon. How many years will my retirement savings last?
2. **Level of payments:** Income yield. What will the amount of my annual income be?
3. **Unexpected balance depletion:** Asset preservation. How high is the risk of my money running out earlier than expected?
4. **Liquidity of balance:** Asset liquidity. If a need arises, how much of my savings can I access?
5. **Volatility of payments:** Income volatility. How much can my retirement paycheck change from year to year?

To gain any additional performance on any one factor generally requires sacrifice in one or more of the other factors. For example, to hedge against longevity risk, one might sacrifice liquidity.

The most prevalent retirement income alternatives are described in Table I.[7]

Why Plan Sponsors May Want to Avoid In-Plan, Insured Decumulation Products

To demonstrate why plan sponsors may want to avoid in-plan, insured decumulation products, consider a guaranteed lifetime withdrawal benefit (GLWB) embedded within the target-date fund (TDF) series, where the TDF is also the qualified default investment alternative (QDIA).[8] Within the TDF, allocations to the GLWB start at age 50.

Plan sponsors should consider the following implications of this arrangement.

- They take on increased fiduciary risk for the initial selection and performance monitoring of the GLWB.
- Being an early adopter could make the plan look like an outlier in the eyes of plaintiffs' attorneys.
- A single in-plan, insured solution may be perceived to be an endorsement of the product.
- Embedded guarantees become autoenrollment mandates where TDFs are also the QDIA.
- The option limits guaranteed income to only those who elect the TDF.
- Given the pace of development, today's products may be suboptimal in less than 15 years.
- Because a limited number of participants will select the product, they will be subject to higher fees and lower returns due to factors including adverse selection.[9]
- A high percentage of participants have low levels of financial literacy and/or numeracy, and many don't understand "plain-vanilla" or "off-the-shelf" TDF designs.[10, 11] Some believe TDFs have always offered guarantees, and most participants won't have considered guaranteed income alternatives.[12]
- Longevity literacy tends to be poor among U.S. adults. Only 32% could correctly answer questions about the life expectancy of 65-year-old men (age 84) and women (age 87).[13]
- Most TDFs use proprietary subfunds, opaque performance metrics and glide paths.
- A GLWB reduces liquidity (or limits liquidity to that which reduces guaranteed income).
- Most importantly, a single product likely will not match participant demographic diversity, including the following four factors.
    1. **Tenure**: Median tenure of all U.S. workers has been less than five years for the past seven decades. Tenure varies significantly by race and ethnicity. Median tenure of workers age 50-plus has been less than ten years for the past five decades. So, more than three-fourths of full-time workers who retire at SS FRA won't have the same employer they had at age 50.
    2. **Life expectancy**: This varies by as much as 20.4 years depending on demographics, including geog-

TABLE I

Most Prevalent Retirement Income Alternatives

Type of Option		In-Plan	Out-of-Plan	Guarantee	Liquid	Standalone	Part of Asset Allocation
Scheduled Payout	Managed payout—Unique fund	✔			✔	✔	✔
	Multiasset solution (e.g., target-date fund, managed account, model portfolio)	✔			✔		
	Asset class (e.g., stock, bond, cash)	✔			✔		✔
	Deferred guaranteed lifetime withdrawal benefit (GLWB)	✔		✔	✔	✔	✔
Ongoing Guaranteed Income	Deferred guaranteed minimum income benefit (GIMB)	✔		✔	✔	✔	✔
	Deferred fixed annuity	✔		✔	✔	✔	✔
Lump Sum Annuity Purchase	Immediate income annuity (single premium immediate annuity)	✔	✔	✔		✔	
	Deferred income annuity (DIA)	✔	✔	✔		✔	
	Annuity platform		✔	✔		✔	
Longevity Insurance	Longevity insurance (qualified longevity annuity contract (QLAC))	✔	✔	✔		✔	✔

raphy, race, urbanicity, income, homicide rate, sex and age group.[14]

3. **Multiple sources of retirement income**: Participants typically have diffused investments of retirement assets among multiple plans and IRAs—and significantly more if both spouses are employed. They may have rolled over Roth 401(k) assets to Roth IRAs.
4. **Marital status**: Variations affect the need for survivor benefits. About 69.8% of men age 65 and over are married, versus 47.3% of women age 65 and over.[15]

Participant preferences are complex and varied. "They want it all . . . Portability to an IRA, flexibility to choose when and how they receive income in retirement, the ability to take a full or partial withdrawal after income has started, growth potential to help address inflation, and protection from market downturns, even if it means sacrificing some potential for higher returns."[16]

However, when the cost of those protections and preferences is identified for each guaranteed income product, deferred SS claiming often emerges as a better "in-plan" solution.

Plan sponsors should (1) encourage consideration of deferred Social Security claiming and (2) consider offering an annuity purchase platform with access to various retirement income products so workers can more accurately meet their individual needs.

Tomorrow: A Better In-Plan Decumulation Default to Consider

For participants who elect to commence payout between ages 62 and 70, plan sponsors should consider amending their 401(k) plan to provide a level-income, autodecumulation default of installment payouts equal to the combination of what is needed to provide a level income until the following events: SS commences at age 70 and RMD commences at the RBD.

The default for those commencing payout prior to age 62 and after age 70 would be deferral until the RBD, requiring the participant to opt out of the default and make a specific election. Facilitating deferral would include changes designed to encourage asset retention, asset aggregation and account consolidation, such as electronic banking, installment payment functionality and 21st century loan processing, etc.

All participants must make financial decisions for claiming SS and taking RMDs. So, all participants should be prompted to consider a level-income decumulation default in their required decision making that would maximize the present value of SS benefits and comply/dovetail with RMDs—a variant of the life cycle theory to achieve sustainable, smoothed, level spending in retirement.

Most U.S. retirees do not have enough guaranteed, inflation-indexed monthly income to maintain their preretirement standard of living. Decades-old studies show that the replacement rate needed to maintain a preretirement standard of living varies by household, from 54% to more than 87%.

A decumulation default of deferred claiming would help to reduce some of the spending gap. Studies show that consumption habits change as retirees age. Many do not need to maintain their preretirement consumption throughout retirement to maintain the same level of financial well-being. Spending in retirement often varies, starting higher in the initial years of retirement, the "go-go" years (to around age 75), declining in the "slow-go" years (to about age 85), then increasing, often due to health costs, in the "no-go" years (after age 85). People later in retirement generally don't need to spend as much to experience comparable satisfaction.[17]

This SS deferred claiming decumulation default is "borrowed" from a pension concept sometimes referred to as a *level-income option*—smoothing the combination of SS benefits and withdrawals from savings over a lifetime.

Deferred SS claiming can be a superior solution in meeting the need for additional guaranteed, inflation-indexed monthly income since benefits are explicitly linked to inflation, unlike all other available guaranteed income products, and are tax-advantaged with superior spouse and surviving spouse benefits.[18]

Research indicates that the break-even investment return on retirement savings required to outperform delayed SS claiming would generally exceed 10% for the life of the retiree, a relatively high hurdle and a significantly riskier strategy.[19]

Simply, the math says delayed SS claiming will optimize benefits.[20]

Why This Decumulation Default?

A decumulation default featuring SS deferral is often superior for the following reasons.

- It avoids adding fiduciary risk; the default is a settlor decision.
- It improves SS/RMD decision making, which are universal decisions for every retiree.
- It reduces fiduciary risk—avoiding conflicted providers, undisclosed spreads, hidden commissions and opaque contracts.
- To increase assets available for guaranteed, inflation-indexed income, it changes the default prior to age 62 and after age 70 to asset retention, soliciting rollovers of retirement assets, favoring asset aggregation and account consolidation.
- The level-income decumulation default applies to those who commence payout between age 62 and age 70, yet it maintains liquidity and control; participants can opt out, or they can start, stop or change payouts at any time.
- It leverages behavioral concepts, such as choice architecture, framing and inertia.
- There are no added fees, sales charges or commissions, and the approach avoids implicit discrimination in annuity pricing and antiselection.
- It has favorable pricing compared with insurance.
- It avoids portability issues; it is not limited by a product, a recordkeeper or interoperability.
- It leaves plan provisions—such as directed brokerage and annuity purchase platforms—unaffected.
- If the QDIA is a target-date model, transitional asset allocation during the bridge period will minimize sequence of returns risk, allowing the following choices.[21]
  - Conservative spending strategy: Spend less to start.
  - Flexible spending strategy: Reduce spending should markets decline.
  - Bucket strategy: Divide assets/vary investments to match anticipated spending and reduce portfolio volatility.
  - Buffer: Allow the participant to tap other assets should markets decline.
- Target-date models are transparent; they notify participants of their actual asset allocation at least five times each year.
- A rational person should adopt a decumulation strategy anticipating extended longevity.[22]

- It adds value for married retirees through enhanced SS spousal and surviving spouse benefits.
- It necessitates perennial communication/education to participants each birthday starting at age 50 and continuing through benefit commencement, which achieves the following.
  - Enhances participant education
  - Prompts identification/confirmation of sources of retirement income[23]
  - Identifies preparation gaps far in advance of retirement with time for "course corrections" to savings rates or to reset expectations
  - Prompts annual consideration of lifetime income needs and (lack of) progress to date
  - Provides more reliable information than mandated retirement income disclosures, which tend to mislead more than inform
  - Encourages asset aggregation and account consolidation
  - Adds experience with the Social Security Administration (SSA) and skill with SS modeling tools
  - Identifies the value of deferred SS claiming
  - Reduces the number of people who are financially unprepared and avoids the higher employment costs of delayed retirement
  - Challenges retirement heuristics and rules of thumb, such as the "4% rule" for retirement income withdrawals, the "100 minus your age rule" for stock allocations and that normal retirement occurs at age 65
  - Prompts consideration of other guaranteed income alternatives available in the individual marketplace if deferred SS claiming does not provide enough guaranteed income

The in-plan default is only a starting point. Communications and marketing should discourage blindly accepting the default, and it should never be expressed as the optimal outcome.

Achieving an optimal result requires each participant to conduct an extensive assessment of retirement goals, assets, liabilities, health, survivor needs and risk appetite. That will not happen without a "nudge" that a default provides.

Importantly, recent studies identified a potential change in perspective regarding using retirement savings to defer claiming of SS where "about half of nonretired IRA-owning households . . . agreed they would take withdrawals to delay Social Security."[24] (Table II)

TABLE II

Balance Preservation Strategies Among Households That Own Individual Retirement Accounts (IRAs)

Strategy	Not Retired	Retired
Delaying taking withdrawals as long as possible	82%	76%
Immediately set up systematic withdrawals to cover expenses	56%	56%
Using a portion to purchase an immediate annuity	22%	14%
Taking withdrawals to delay claiming Social Security	49%	19%

Source: S. Holden and J. Seligman, *Older Households' Goals and Resources Throughout Retirement.*

Operationalizing the Decumulation Default

The basic steps for implementing the decumulation default include the following.

- Start communication and education when participants turn age 50 to supplement mandatory disclosures such as the lifetime income projections.
- Make an annual request to the SSA to confirm the SS primary insurance amount payable at SS FRA for both participant and spouse (if any).
- Add a SS optimization tool that allows participants to adjust longevity and other assumptions.
- Provide education to prompt participants to annually use the optimization tool to identify the optimal commencement date and to confirm the additional benefit of guaranteed, inflation-indexed income possible by deferring SS commencement to age 70, while presenting the estimated amount of assets necessary to bridge SS deferral.
- Create an estimation tool incorporating an algorithm that actuarially estimates the level-income stream

needed to "dovetail" with deferred commencement of SS and RMDs to create a level income for life.[25]

Other Plan Design Changes

Plan sponsors seeking to facilitate this autodecumulation default should also consider the following features.

- **Asset retention:** Confirm in education that the 401(k) is a separate legal entity, a "lifetime financial instrument."[26]
- **Plan loans:** Add or update plan loan administration to 21st-century functionality. A third or more of surveyed 401(k) plans allow for postseparation loan repayment.[27]
- **Asset aggregation and account consolidation:** Accept all rollovers/direct transfers, from both predecessor and subsequent employer-sponsored plans, and adopt traditional and Roth-deemed IRAs to minimize inadvertent investments in capital preservation.[28] Minimizing the number of accounts ensures that expenses are also minimized and that the 401(k) presents a holistic view of retirement savings.
- **Flexible withdrawal options:** Allowing partial and systematic withdrawals, including ad hoc and installments, provides access to a portion of the account balance.[29]
- **Target-date models:** These options should maximize transparency, minimize fees and minimize fiduciary risk.[30]

Conclusion

This solution can be optimal only if—in addition to optimizing SS claiming—it prompts many workers to increase savings rates or otherwise adjust their plans for retirement when considering their retirement income needs.

If "income is the outcome" and if inflation-indexed, guaranteed, lifetime income is a priority, you may find that this one-size-fits-all decumulation default offers superior value.

Confirming detailed, personalized assets at age 50 may help workers identify retirement income needs, accumulated assets and gaps, which may prompt those with modest 401(k) assets to better consider their readiness to retire.

It may also prompt individuals with greater income replacement needs to confirm that this default would not be adequate by itself and to consider additional individual insurance products. BQ

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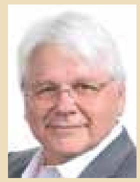

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