Approaches for Promoting Voluntary Annuitization

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Background

As employers have shifted their primary retirement plan vehicles from defined benefit (DB) to defined contribution (DC), individuals are experiencing big increases in their longevity risk. Most individuals are not even aware of this risk and are woefully unprepared for managing or mitigating it. Further compounding the problem, lump sums have become the predominant form of distribution from DC plans, and in many cases they are the only distribution form.[1] Even when lump sums are rolled over to an Individual Retirement Account (IRA), very little of these assets are ever annuitized. What are the implications of shifting longevity risk to individuals? Most people find longevity risk difficult to understand and even more difficult to quantify. More importantly, longevity risk is difficult for individuals to mitigate. The risk is quite predictable and manageable when pooled, but not simple to predict or manage at the individual level. As a result, individuals either overestimate the risk and reduce consumption excessively to conserve assets, or underestimate and run out of assets too early.

Yet, individuals are reluctant to choose life annuities as a way to reduce longevity risk. There are many reasons for this reluctance, including:

- Fear of losing control of assets
- Lack of knowledge about annuity products and markets
- Fear of dying before receiving their "money's worth" from their annuity purchase.

Despite these reasons for avoiding annuities, 47 percent of American adults worry that they will outlive their money.[2]

While mandatory annuitization could provide relief, government or employer mandates to annuitize DC benefits are probably not feasible in the near term. Individuals highly value "choice" and prefer as many options as possible. In addition, most DC plans have at least some element that is employee-funded through voluntary deferrals. Employees view these benefits as "their" money and resent government restrictions on access to or use of these funds. Compounding the problem, employers have gradually eliminated annuities as DC plan distribution options, both to simplify administration and to avoid fiduciary liability for selection of the annuity provider. Even DB plan sponsors often encourage employees to elect lump sums, as they seek ways to reduce their financial risks under DB plans and also in response to employee demand.

Insurance companies, too, have not been eager to promote their annuity products. The annuity market in the United States is small. Insurers view annuity sales as time consuming and not very profitable relative to other product lines. Adverse selection affects annuity pricing and, in turn, higher prices cause the public to perceive annuities as a poor value. Although annuities are starting to receive media attention as a tool for aging baby boomers, most individuals are ignorant of what longevity risk is, how severely it can affect their financial well-being and how to mitigate it.
Given that individuals highly prize choice and resent government intrusion in financial matters, are there approaches that promote annuitization while still preserving individual autonomy? This paper will explore various incentives that government or employers could employ to encourage voluntary annuitization. Additionally, it will consider ways to improve annuity pricing for individual purchases.

Incentives for Promoting Voluntary Annuitization Government Incentives

Government has an interest in ensuring that individuals do not become indigent in old age. Those who outlive their assets will need government assistance. While many current retirees rely substantially on Social Security benefits, the Social Security program in its current form likely will not support all of the promised benefits to the baby boom generation.

A two-pronged taxation approach could encourage voluntary annuitization: a tax reduction for those who annuitize and tax penalties for those who do not.
In recent years, Congress has considered a number of bills that would exempt a portion of the income attributable to annuities purchased directly by individuals. These proposals did not receive much attention, but the idea has much merit.
Exempting all annuity-generated income from taxes would not be feasible for revenue reasons. However, even a partial tax exclusion could encourage individuals to elect annuity distributions from DC plans or to annuitize other assets. Examples of a partial exclusion are exempting the first $10,000 of annual annuity income from taxable income or applying a lower tax rate to annuity income.

The tax penalty side of the two-pronged approach could take the form of an excise tax on lump sum distributions that are not annuitized by age 70 or 75. Small lump sums (less than $5,000) could be exempt.

Another type of incentive would be government-funded (i.e., taxpayer-supported) matching funds applied to a portion of the principal sum that is annuitized. For

example, the first $150,000 of funds that an individual uses to purchase a life annuity would be eligible for a 20 percent match, so a $100,000 premium investment would become a $120,000 investment. Appropriate conditions would apply, such as requiring that the annuity be purchased from a qualified insurance company on an actuarially sound basis.

A third type of government incentive would be for the government to subsidize the annuity purchase. Under this approach, the individual would purchase an annuity from the Social Security Administration (SSA) as a supplement to the Social Security benefit. In addition to benefiting from the convenience and low administrative cost offered by the SSA, the government could offer the supplemental annuities at a subsidized premium rate.

Employer Incentives

Employers also have an interest in ensuring that their retirees have adequate retirement income. As employers shift longevity risk to employees through DC plans, they should bear some responsibility for helping retirees manage the risk. At a minimum, they should provide employees with the appropriate tools and vehicles for risk mitigation.

One approach would be for the employer to match the participant's investment allocation in a deferred annuity option. For each dollar so invested, the employer could match a percentage (e.g., 25 percent), up to an annual or lifetime cap. This matching contribution would be in addition to the plan's regular match, if any.
Another employer incentive would be to match funds at the time of distribution. For each dollar converted to a life income option, the employer would match a percentage, again subject to a cap.

A third type of employer incentive would be to subsidize the plan's annuity conversion factors. This approach would operate best in a DB plan, where employer contributions are not allocated by participant. However, it might also be adapted to the DC plan environment by having the annuity provider charge an annual fee to the employer to provide the premium subsidy. The employer would need to monitor the arrangement to ensure that the subsidies do not discriminate in favor of highly compensated employees either in form or in operation.

Expanded Catch-up Opportunities

Currently, many public sector employers allow employees to convert their accumulated leave (i.e., sick pay, vacation pay, etc.) to a 401(a), 403(b) or 457 plan contribution at the time of retirement. This feature offers a valuable opportunity for a lump sum catch-up contribution at retirement. However, the concept is limited by Internal Revenue Code limits on elective deferrals and by the lack of significant leave banks in the private sector. The approach could be expanded by allowing unlimited DC plan contributions in the final year before retirement, but only if the converted funds are applied to the purchase of a life annuity.

Methods for Facilitating Annuitization

Portability Approaches

Currently, it is difficult, if not impossible, for an employee to transfer a deferred annuity from an employer's DC plan to another qualified plan without liquidating the annuity and rolling over a cash lump sum. Another impediment is that the new employer's plan may not offer a deferred annuity as an investment option.
Plan sponsors also face challenges when changing recordkeepers. The new recordkeeper may not be able to administer the deferred annuities that were established on a prior recordkeeping system.

To overcome these difficulties, insurer cooperatives could be developed to facilitate the transfer of deferred annuities from one plan to another and between recordkeepers. These cooperatives could also establish standard annuity features to facilitate portability. With such cooperatives and portability standards in place, more employers would be encouraged to offer deferred annuity investment options within their plans.

Employee Education Enhancements

Employers have responded to the challenge of communicating savings and investment concepts to their employees to help them prepare for retirement. Employee investment education programs and tools are now considered standard features of DC plans in the United States. One area still lacking from many employers' education programs, however, is advice on account spend-down. Employees need to understand the risks associated with the spend-down phase. They also need to understand the

techniques available to mitigate these risks and have access to the appropriate tools for implementing the techniques.

In addition to enhancing employee education programs to include spend-down topics, employers could offer professional distribution advice, similar to the professional investment advice already authorized by the Department of Labor (DOL). Specialists on distribution planning could counsel employees on spend-down methods appropriate for their individual situations. Such offerings might require guidance, approval or oversight by the DOL.

To caution employees against electing a cash lump sum, the Internal Revenue Service (IRS) could require that employers provide a written notice to all employees electing lump sums or installments over 10 years or less. Similar to the rollover notice already required, this notice would outline the risks associated with longevity and explain how a lump sum exacerbates the risks.

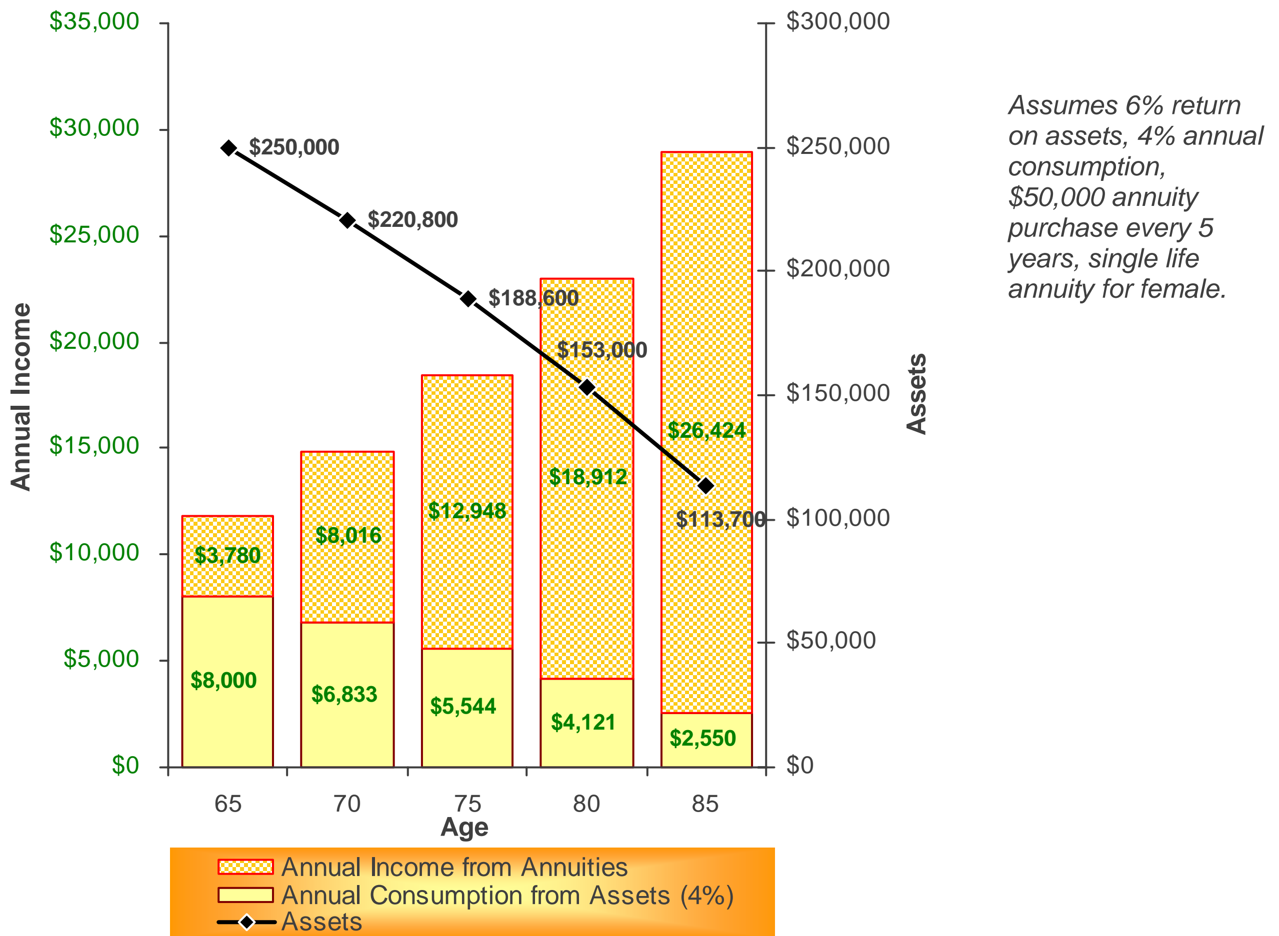
A similar requirement could apply during participants' active plan participation. The IRS could require language on participants' quarterly DC plan statements to educate employees about longevity risk and the value of annuitization. Reporting retirement income amounts in addition to the lump sum account value on participant statements would also help employees to plan ahead and might increase contribution rates, as well.

Annuitization in Stages

Annuitizing one's assets in stages has a great deal of merit. Like dollar-cost averaging during the accumulation phase, annuitizing in stages spreads the interest rate risk over a variety of interest rate environments. It also leaves a larger portion unannuitized in the early years, to provide for bequests to dependents in case of premature death, while guaranteeing more and more lifetime income in later years to protect against inflation risk.

Employer-sponsored plans could facilitate annuitization in stages by providing for periodic reassessments, say every five years, after retirement. In the reassessment, the retiree could take a new look at income needs, assets and spending patterns and decide whether to annuitize another portion of his or her remaining account balance. Portions already annuitized would remain annuitized. This approach would be like account rebalancing for the spend-down phase.

This example assumes an account balance of $250,000 at age 65. The retiree uses $50,000 of the account to purchase an immediate annuity at ages 65, 70, 75, 80 and 85.



The black line depicts the declining amount of unannuitized assets. The bars represent annual income: the orange portion is the increasing annuity income and the yellow portion is the declining income from the unannuitized assets.

While this example uses equal annuity purchases, a retiree would probably vary the amounts, depending on current and future needs and on investment gains and losses.

Default Approaches for Promoting Voluntary Annuitization

Government Mandates

Currently the qualified joint and survivor annuity (QJSA) is the default distribution option for defined benefit and money purchase pension plans only. To encourage more participants to annuitize their benefits, Congress could mandate the QJSA as the default

option for all qualified and nonqualified retirement and deferred compensation plans. Alternatively, the QJSA could be the mandated default for a percentage of the benefit, or for benefits below a specified dollar amount, which could be indexed for inflation.

Another possibility for the default distribution form would be installments over a 20-year period combined with longevity insurance. If the retiree survives the full 20 years, the insurance provides a life annuity commencing at that time.
Facilitating split distribution forms, such as a partial lump sum combined with an annuity, would also encourage annuitization.

Automatic Rollover Changes

Currently mandatory plan cashouts between $1,000 and $5,000 must be rolled over to an IRA unless the employee directs otherwise. Congress could relieve employers of the burden of selecting an IRA provider by mandating that the automatic rollover go to the SSA instead. The amount rolled over to the SSA would be paid as a supplemental annuity when the Social Security benefit begins. Alternatively, Congress could mandate another pre-approved annuity provider in lieu of the SSA.

To make this approach even more robust, the automatic rollover threshold could be increased from $5,000 to $20,000 and the lower limit of $1,000 could be eliminated. The lower limit was added to avoid having millions of small IRA accounts being established in which administrative costs might exceed the account value. To summarize, all benefit amounts under $20,000 would be rolled over automatically to the SSA or other annuity provider to provide a deferred annuity unless the distributee makes a distribution election.

Employer Mandates

Most DC plans currently provide a lump sum as the default distribution form and a large percentage offer no other options. Employers avoid offering other choices, reasoning that participants can roll over their account balance to an IRA and take any kind of distribution form available under the IRA.

While the reasoning is sound, it neglects the education side of the distribution equation. Counseling by IRA providers is very good for those who seek it out, but nonexistent for those who don't. Furthermore, the vast majority of IRAs are never converted to an annuity.3

A better approach would be for employers to voluntarily make a QJSA or single life annuity the default distribution option. Such a change would also offer the opportunity to counsel employees on the benefits of annuitization. Because many employees view the default as the "recommended" approach, and others fail to overcome inertia to actively select another option, more accounts would be annuitized over time. Employers might also consider a default consisting of installments combined with longevity insurance, as described above.

Approaches for Improving Annuity Pricing and De-concentrating Risk

Many individuals perceive annuities as being too costly. Anti-selection does drive prices up, because individuals have better knowledge of their own life expectancy than do the insurers. Additionally, individuals and small employers lack the opportunity to purchase annuities at more favorable group rates available to large employers. Currently, longevity risk insurance in the United States is concentrated in DB plans (both public and private) and a few large insurance companies. Recent economic events involving near failure of several large U.S. financial institutions demonstrate how risk concentration of this nature can unravel the financial markets. Broadening the risk pool through federal or state action would lessen the risk concentration.

Allowing elective rollovers from retirement plans to the SSA would be one method of de-concentrating longevity risk. The SSA could accept a qualified plan rollover to purchase a supplemental annuity, either fixed or variable, payable when the individual's Social Security benefit begins. The convenience plus the government guarantee backing the annuity might encourage many individuals to annuitize who otherwise would not. In addition, the SSA could offer such supplemental annuities on a subsidized basis, as described above. Employers would benefit, as well, because they would not bear any fiduciary responsibility for selection of the annuity provider.

To make annuities more affordable, states or nonprofit organizations could sponsor purchasing coalitions, much like those formed for group purchasing of health insurance. The coalitions would negotiate more favorable group pricing from the annuity providers for their employer members. The National Association of Insurance Commissioners could provide model legislative language for states to set up and regulate such coalitions.

Another approach would be for states to allow small employers and individuals to purchase annuities either from or through the state retirement systems. Again, more favorable group pricing would be possible and bulk purchases and automated processes could produce cost-saving efficiencies.

Tax incentives could also be used to improve annuity pricing. Either the federal or state governments could offer tax credits or tax deductions to insurers to support annuity purchases by individuals. Such tax benefits could be focused on rewarding the insurer for increasing its annuity sales relative to average levels prior to the introduction of the tax benefit. In subsequent years, the tax benefits could be targeted to reward year-over-year increases in annuity sales. Possible measures could include both number of annuities sold and premium volumes. Combining insurer tax benefits with individual tax benefits would address both sides of the annuity purchase transaction. The tax credits or deductions could be supplemented by a government-funded education campaign to make individuals aware of longevity risk and how to mitigate it. Finally, annuities could be securitized through a government agency. This approach would free up insurance company assets for other uses and allow insurers to realize profits earlier.

Conclusion

Reluctance by individuals to annuitize must be overcome. We need to increase the public's knowledge of longevity risk and make the annuitization process easier and more transparent. We also need to improve annuity pricing and the public's perception of annuity value.

A variety of strategies are possible for government and employers to encourage voluntary annuitization. Some approaches involve government expenditures or costs to employers, such as tax benefits or employer matching funds. Others primarily make annuity purchases automatic or more convenient. A multi-faceted strategy would prove most successful because individuals respond differently to different incentives.
This author hopes that these and similar ideas can receive further consideration so that individuals will eventually feel more comfortable with the concept of annuitization. Future research in this area should explore how much annuitization is optimum, what types of organizations are best suited for pooling longevity risk, and the role of government in promoting annuitization.

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[1] *Profit Sharing/401(k) Council of America. 2009. 51st Annual Survey of Profit Sharing and 401(k) Plans. Chicago, IL. Page 49.*

[2] *Jacobe, Dennis. 2008. "Many Americans Fear They'll Outlive Their Money." Gallup, Inc., Princeton, NJ. Feb. 27, 2008.*

[3] *Among retirees sampled in 1999, private annuities accounted for less than 2 percent of total household income. Gale, William G., J. Mark Iwry, David C. John, and Lina Walker. June 2008. "Increasing Annuitization in 401(k) Plans with Automatic Trial Income." The Hamilton Project: Advancing Opportunity, Prosperity and Growth. Discussion Paper 2008-02. The Brookings Institution. Page 5.*