# 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.[i] 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.[ii]

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.

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

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