Removing the Legal Impediments to Offering Lifetime Annuities in Pension Plans

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Achieving Better Retirement Outcomes: Solutions for a Modern Workplace
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About this Research

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Longevity Risk

• Risk of outliving your retirement savings
  – 65-year-old American man: 50% chance of living to 82; 20% chance of living to 89
  – 65-year-old American woman: 50% chance of living to 85; 20% chance of living to 92
  – 65-year-old American couple: 50% chance that at least one will live to age 88; 30% chance that at least one will live to 92

• Retirements can last for 30 years or more
Retirement Income in the U.S.

• 48.6 million retirees in 2014
  – 66.4 million in 2025
  – 82.1 million in 2040

• Sources of Retirement Income
  – Social Security
  – Pensions
  – Individual Retirement Accounts (IRAs)
  – Annuities
  – Individual savings & a savings withdrawal plan
Overview of the U.S. Economy

- Population ~ 323 million
- Gross Domestic Product ~ $18 trillion
- $53,657 Median Household Income in 2014
- $28,851 Median Wage in 2014
  - $44,569 Average Wage
- 2016 Federal Poverty Guidelines
  - $11,880 for a one-person household
  - $16,020 for a two-person household
Social Security

• Social Security
  – Inflation-adjusted pension benefits
  – 40.2 million retirees
  – $1344 per month, average benefit

• Supplemental Security Income for the poor
  – 2.1 million elderly beneficiaries
  – $435 per month, average benefit
Pensions, IRAs & Annuities

• $27.3 Trillion Retirement Savings
  – $11.3 trillion in defined benefit plans
  – $6.3 trillion in defined contribution plans
  – $7.4 trillion in IRAs
  – $2.3 trillion in annuities
A Voluntary Retirement Savings System

• At any point in time, only about half of American workers have a pension
  – 66% of private-sector workers have access
  – 49% participated

• Participation in IRAs is even lower

• Individuals rarely buy annuities
Pensions: Favorable Tax Treatment

• Employer contributions to a pension are not taxable to the employee
• The pension fund’s earnings on those contributions are tax-exempt
• Employees pay tax only when they receive distributions of their pension benefits in retirement
• Exempt/Exempt/Taxable (EET)
Annuities in Defined Benefit (DB) Pension Plans

• Traditional DB plans pay out as lifetime annuities
  – Qualified joint-and-survivor annuity (QJSA) for married couples
  – 68% of workers who retired from 2000–2006 took the annuity
  – Unfortunately, lump sums are often available
    • The lump sum amount is equal to the actuarially-determined present value of the participant’s expected stream of lifetime pension benefits
Annuities in Defined Contribution (DC) Pension Plans

• Major shift from DB plans to DC plans
• DC plans rarely offer annuities
  – 401(k) plans are the most popular
    • Allow individuals to tax-shelter up to $18,000/year
  – DC plans may offer annuities among their investment options
  – DC plans may offer annuities at retirement or job separation
  – DC participants can usually take a lump sum distribution & later buy an annuity
Individual Retirement Accounts (IRAs)

• In 2016, individuals can contribute and deduct up to $5500 to an IRA

• Like private pensions, IRA earnings are tax-exempt, & distributions are taxable.

• Individuals & IRAs can buy annuities from insurance companies
Annuities

- Somewhat favorable tax treatment
  - No tax until distributions begin
- $100,000 would get a 65-year-old man a fixed annuity of $6540 a year for life (6.54%)
  - Inflation-adjusted annuities
  - Deferred income annuities
- State insurance departments regulate annuities
The Role for Annuities

• With the disappearance of DB plans, American workers have to create their own retirement income solutions

• That is where annuities come in, but there is always a low demand for annuities
  – The annuity “puzzle”
  – Individuals underestimate their life expectancies; overvalue their wealth
  – Retail annuities are overpriced
Demographics of Life Expectancy

• Life expectancy varies with such demographic factors as gender, income, educational level & race
  – Women live longer than men
  – Rich live longer than poor

• Some policies to encourage greater annuitization could be unfair to some groups
What Can the U.S. Learn from Other Countries?

• The demand for lifetime annuities is consistently low in most of the world

• But there are exceptions
  – Netherlands—pension benefits must be paid out in the form of an inflation-adjusted annuity to qualify for tax benefits
  – Switzerland—80% converted to annuities
  – Chile—70% choose lifetime annuitization of their public pension benefits (over the phased-withdrawal alternative)
Many Countries Are Moving Away from Annuitization

- Australia—annuities are rare
- The United Kingdom (UK) used to have high lots of annuitization
  - Stopped requiring retirees to buy annuities
    - Now UK even allows current annuity holders to sell
      - These changes raise a lot of tax revenue
- Trend is towards individual choices
  - even if those choices result in less annuitization & more poverty among the elderly
What Can the U.S. Learn?

• Other countries offer ways to
  – Increase participants’ knowledge and understanding of their spend-down options
  – Make it harder for financial advisers to charge high commissions or offer inappropriate investment advice
  – Incentives & withdrawal rules
  – Rely on insurance regulators instead of fiduciary duties
Options for Reform

• Increase & Preserve Retirement Savings
• Reform the Tax Treatment of Annuities
• Mandate or Encourage Annuity Annuitization
• Improve Annuity Regulation and Markets
Increase & Preserve Retirement Savings

• Encourage workers to save more
  – Larger nest eggs at retirement
  – Greater ability to buy annuities
  – Adopt a mandatory universal pension system like Australia, Singapore & Chile
  – At least require employers to offer a plan, with automatic enrollment
    • Like the UK’s new National Employment Savings Trust (NEST) program
Increase & Preserve Retirement Savings

• Help workers get better returns on their retirement savings
  – Encourage stock market investments
  – Better regulate fees & expenses
  – Encourage retirees to keep their savings in their relatively low-cost pension plans
    • as opposed to rolling their balances over into relatively high-cost IRAs
Increase & Preserve Retirement Savings

• Encourage individuals to work longer
  – Raise Social Security ages (62, 67, 70)
  – Raise pension ages (59½, 65, 70½)

• Preserve benefits until retirement
  – E.g., discourage early withdrawals & loans
  – Discourage rollovers to IRAs
Increase & Preserve Retirement Savings

• Revise the rules for calculating lump sums
  – Use the latest mortality tables
  – Use the latest interest rates
  – Notices should explain how hard it is to invest a lump sum to get lifetime income
Reform the Tax Treatment of Annuities

- Favorable tax rules should encourage the election of lifetime income streams
- Possibly provide additional tax benefits for individuals who receive income from lifetime annuities & lifetime pensions
  - Complete exemption from income taxation?
  - Or a reduced tax rate?
  - Target the benefit towards low-income?
Mandate or Encourage Annuitization

• Require that retirees use at least a portion of their retirement savings to purchase annuities; or

• Just encourage annuitization
  – Require pensions to include annuities as
    • investment options; and/or
    • distribution options
  – Encourage plans to offer partial annuitization
  – Default workers into annuities
Encourage Annuitization

• Government could sell annuities
• Make it easier for plans to offer annuities
  – Let plans rely on insurance regulators to oversee and monitor annuity products
• Promote financial education about annuities
  – Lifetime income calculators
  – Life expectancy calculators
Improve Annuity Markets

• Strengthen the market for annuities
  – Simplify regulation
    • Federal insurance company charters
    • Strengthen the guaranty funds

• Allow more lifetime income products
  – especially products that pool participant risk
    • TIAA’s College Retirement Equities Fund (CREF) offers a variety of low-cost variable annuities
    • Defined ambition plans (Netherlands)
    • Tontine annuities, tontine pensions & survivor funds
Tontines

• Tontines are investment vehicles that combine features of an annuity & a lottery

• Investors pool their money
  – Each year they are alive, members receive investment income
  – As members die, their shares are forfeited to the surviving members (“mortality gains”)

• Can be used to create tontine annuities, tontine pensions, and survivor funds
Conclusion

• Lifetime pensions & annuities provide the best protection against longevity risk.
• Changes in the U.S. laws & regulations could help
  – Make voluntary annuitization more attractive;
  &
  – Get pensions to offer more annuity options & to encourage employees to elect those options
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