The Role of Annuities in Retirement Plans

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Innovating for New Retirement Solutions
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Longevity Risk

• Risk of outliving your retirement savings
  – 65-year-old man: 50% chance of living to 83; 20% chance of living to 91
  – 65-year-old woman: 50% chance of living to 86; 20% chance of living to 94
  – 65-year-old American couple: 50% chance that at least one will live to age 90; 30% chance that at least one will live to 94

• 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 & savings withdrawal plan
Pensions, IRAs & Annuities

• $34.8 trillion Retirement Savings in 2018
  – $15.4 trillion in defined benefit plans
  – $7.5 trillion in defined contribution plans
  – $9.2 trillion in IRAs
  – $2.7 trillion in annuities (~ 8 percent)
Social Security

• Social Security
  – Inflation-adjusted monthly benefits
  – 43.7 million retired workers in December 2018
  – $1,461 per month, average benefit
  – & Medicare from age 65

• Supplemental Security Income for the poor
  – 2.3 million elderly beneficiaries
  – $446 per month, average benefit
Annuities

- A typical annuity is an insurance contract that converts a lump sum of money into a stream of income payable over a period of years, typically for life.
- $100,000 would get a 65-year-old man a lifetime annuity of ~ $6,700 a year for life (6.7%) in December of 2018.
  - $6,300 for women (6.3%)
A Voluntary Pension System

- At any point in time, only about half of American workers have a pension
  - 66% of private-sector workers had access
  - 50% participated
- Participation in IRAs is even lower
- Individuals rarely buy annuities
Pensions Get 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
Defined Benefit Plans

- Employer promises employees a specific benefit at retirement.
  - Benefits often tied to years of service (yos) & final average pay (fap)
  - E.g., a worker who retires after 30 years of service with final average pay of $100,000 would receive a pension of $60,000 a year for life
    - $60,000 = 2% $100,000
Annuities in Defined Benefit Plans

• Traditional Defined Benefit 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
Defined Contribution Plans

- Employer may contribute, say, 5% of pay to an account for the worker
  - E.g., a worker who earned $100,000 in a given year would have $5,000 contributed to an individual investment account for her ($5,000 = 5% \times $100,000)
  - 401(k) plans are the most popular
    - Individuals can also contribute
    - Up to $19,000 in 2019
Annuities in Defined Contribution Plans

- DC plans rarely offer annuities/usually make lump sum distributions
- DC plans
  - May offer annuities among their investment options
  - May offer annuities at retirement or job separation
  - Retirees can usually take a lump sum distribution & buy an annuity later
Individual Retirement Accounts (IRAs)

• Individuals can contribute up to $6,000 per year in 2019
• Like private pensions, IRA earnings are tax-exempt, & distributions are taxable
  – Different tax rules for Roth IRAs
• Individuals & IRAs can buy annuities from insurance companies
Annuities

• Somewhat favorable tax treatment
  – No tax until distributions begin

• Many types of annuities, including
  – Traditional Fixed Annuities (e.g., for life)
  – Inflation-adjusted annuities
  – Deferred income annuities (longevity insurance)
  – Variable annuities
State Regulation of Annuities

• With a typical annuity, an insurance company bears the risk of making certain guaranteed payments, and because insurance companies bear such risks, they are heavily regulated and must maintain adequate reserves

• State-based guaranty funds
  – Most states provide at least $250,000 in benefit protection for annuities
The Role for Annuities

• Major shift from Defined Benefit plans to Defined Contribution plans
  – Therefore, most Americans need to create their lifetime income solutions
  – Annuities can help, 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 low around the world

• But there are exceptions
  – Netherlands—pension benefits must be paid out as an 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)
But Many Countries Are Moving Away from Annuitization

• Australia—annuities are rare

• The United Kingdom (UK) used to have high levels of annuitization
  – Stopped requiring retirees to buy annuities

• Trend is towards individual choice
  – Even if those choices result in less annuitization & more poverty among the elderly
What Can the U.S. Learn from Other Countries?

- Other countries do offer ways to
  - Increase retirees’ knowledge and understanding of their spend-down options
  - Make it harder for financial advisers to charge high commissions or offer inappropriate investment advice
  - Provide incentives for annuitization & place limits on distributions
  - Allow plans to rely on insurance regulator determinations of insurance company stability
Options for Reform

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

• Encourage workers to save more
  – Larger nest eggs at retirement & a greater ability to buy annuities
  – Adopt a mandatory universal pension system like Australia, Singapore & Chile
  – Or at least require employers to offer a plan, with automatic enrollment
    • Like the United Kingdom’s new National Employment Savings Trust (NEST) program
    • Multiple employer plans might increase coverage
    • Payroll-deduction IRAs & state-run plans
Increase & Preserve Retirement Savings

• Help workers get better returns on their retirement savings
  – Encourage stock market investments
    • Target-date funds
  – Better regulation of fees & expenses
  – New retirement annuity products with higher yields?
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
  – Discourage early distributions & loans
  – Discourage rollovers to IRAs
  – Discourage lump sum distributions
    • Notices could explain how hard it is to invest a lump sum to get lifetime income
Reform the Tax Treatment of Annuities

• 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?
    • E.g., a tax benefit, but just for the first $20,000 or $30,000 of annuity income
Encourage Annuitization

• Government might require retirees to use a portion of their pensions to buy annuities
• Or government might just encourage annuities
  – Require pensions to include annuities as
    • investment options; and/or
    • distribution options
  – Make plans offer partial annuitization
  – Require plans to default workers into annuities
Encourage Annuitization

• Government might even sell annuities
  – E.g., the Social Security Administration

• Make it easy for plans to offer annuities
  – E.g., 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 annuity providers to advertise their state guarantees
  – No-advertising rule/moral hazard
  – But allowing advertising would bolster consumer confidence in annuities
Allow More Lifetime Income Products

• Especially products that pool longevity and investment risks
  – Pooled annuities
  – TIAA’s College Retirement Equities Fund (CREF) offers a variety of low-cost variable annuities
  – Defined ambition plans (Netherlands)
    • Share risks among participants
  – Tontine annuities and pensions
Tontine Annuities & Tontine Pensions

• Tontines are investment vehicles named after the 17th century Italian banker Lorenzo de Tonti

• In a simple tontine, investors pool their $$
  – 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 and tontine pensions
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; &
    • encourage employees to elect those options
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