Better Financial Security in Retirement? Realizing the Promise of Longevity Annuities

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November 6, 2014
Defined contribution plans are replacing traditional defined benefit plans

<table>
<thead>
<tr>
<th></th>
<th>1989-90</th>
<th>2003</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Any plan</td>
<td>62%</td>
<td>58</td>
<td>59</td>
</tr>
<tr>
<td>Defined benefit</td>
<td>42</td>
<td>24</td>
<td>19</td>
</tr>
<tr>
<td>Traditional</td>
<td>na</td>
<td>18</td>
<td>13</td>
</tr>
<tr>
<td>Cash balance</td>
<td>na</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Defined contribution</td>
<td>40</td>
<td>48</td>
<td>51</td>
</tr>
<tr>
<td>Defined contribution only</td>
<td>20</td>
<td>34</td>
<td>40</td>
</tr>
</tbody>
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Full-time Private-Sector Workers Participating in Retirement Plans by Type, Selected Years (percent)

Balances in retirement savings accounts have grown

**Defined Contribution Plan Balances, Selected Years, 1989-2013 (in 2013 Dollars)**

Source: Authors’ tabulations, Survey of Consumer Finance data
Until recently, less attention has been paid to helping retirees decumulate their retirement assets

• Retirees face many risks, including
  • Longevity risk
  • Health care expenditure risk
  • Inflation risk
  • Financial return risk
  • Housing market risk

• Financial instruments for addressing many of these risks are not readily available, especially not in the context of employer DC plans and, where available, seldom used
Person age 60 in 2010 has 30 percent chance of living more than 5 years beyond median projected age for their gender.

Projected Probability of Survival to Indicated Age, Assuming No Further Mortality Improvements

Source: Authors’ calculations using SSA 2010 Period Life Table.
Longevity annuity addresses risk retiree will outlive assets

- Longevity annuity is an insurance product
  - Purchased at age 65, 60 or even earlier
  - Pays monthly annuity beginning at age 75, 80 or 85
  - Could in principle be indexed for inflation

- Provides income in later years at substantially lower cost than an immediate annuity
  - Insurance company has more time to realize returns on premium
  - Benefits paid for fewer years
  - Large part of income payments financed by policy holders who do not survive long enough to collect

- Retiree can spend down remaining assets over fixed time horizon without fear of running out of money
  - Longevity annuity provides much of the insurance value of a conventional annuity at a fraction of the cost (Gong and Webb 2007)
<table>
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<tr>
<th>Deferral period</th>
<th>60 year old male</th>
<th>60 year old female</th>
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<tbody>
<tr>
<td>0</td>
<td>$534.50</td>
<td>$510.79</td>
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<td>5</td>
<td>$747.90</td>
<td>$708.72</td>
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<td>10</td>
<td>$1,052.08</td>
<td>$988.02</td>
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<tr>
<td>15</td>
<td>$1,574.75</td>
<td>$1,469.68</td>
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<tr>
<td>20</td>
<td>$2,538.70</td>
<td>$2,318.05</td>
</tr>
<tr>
<td>25</td>
<td>$4,501.86</td>
<td>$3,933.03</td>
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Source: Authors' communication with Hueler Associates.

Note: Reported monthly annuity amounts are for a single life annuity with no inflation adjustment and no return of premium.
Why have more individuals not sought to purchase longevity annuities?

- Lack of understanding of longevity risk
  - Analysis of data from the Health and Retirement Study shows many individuals understate the chance they will live to age 75 or beyond
- Many of same factors that explain lack of annuitization more generally
  - Already effectively annuitized through Social Security
  - Perception that value is poor
  - Financial advisors prefer to keep wealth under management
- Lack of longevity annuity option in employer plans
- Minimum distribution requirements have inhibited purchase with funds from retirement account
  - Partially addressed by July 2014 Treasury regulations
- Fear that insurance company won’t be able to make longevity payments
  - Not well-supported by historical experience—insurance company failures are rare and liabilities they cannot pay largely have been covered by state guaranty associations
Additional factors may impede employer and insurance company participation in the longevity annuity market

• Employers concerned about fiduciary responsibility associated with annuity products purchased from an insurance company
  • Share of employers offering annuities as retirement plan option is low
  • Fiduciary requirement often cited as an important reason
• Insurance companies face uncertainty about mortality risk twenty or more years in the future
• Small number of market players may mean products are not priced as competitively as would be the case with more providers
Proposal #1: Develop informational materials about annuity products and annuity providers for consumers

• Graphic modeled on the MyPlate graphic for nutrition (formerly the food pyramid) to guide financial decision-making
  • Graphic could point individuals towards potentially useful products such as longevity annuities, and provide information about population for whom products might be appropriate
  • Candidates to develop graphic include the Office for Older Americans, CFPB or the Social Security Administration

• Certification of financial products—including longevity annuities—based on standards for reliability, cost and quality
Proposal #2: Permit insurance companies to mention state guaranty association coverage in their marketing materials

- State guaranty associations back annuity commitments by insurance companies operating in the state
  - Insurers in state pledge to support guaranty fund up to some defined threshold
  - Fund pays benefits due policy holders of failed companies up to maximum specified by state law, currently $250,000 in most states
- Laws in most states prohibit insurance companies from mentioning guaranty association coverage in advertising their products
- Making consumers aware of guaranty association coverage could contribute to more realistic assessments of the riskiness of annuity products
Proposal #3: Create more transparent and easily verifiable safe harbor for employers who offer annuities as a plan option.

• Current safe harbor provision includes problematic requirement that employer:
  “Appropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract”

• Difficult for most employers to make this determination and, just as important, to feel confident they will not later be held liable in the event of a problem

• Two options would be to give safe harbor for selection of insurance company that
  • Has been licensed in at least 26 states (ACLI suggestion) OR
  • Meets a specified threshold on the Insurance Financial Strength Rating
Proposal #4: Offer a longevity annuity option in the federal Thrift Savings Plan (TSP).

- As of 2012, the TSP covered 4.6 million people and had over $300 billion in assets
- Offering a longevity annuity option to TSP participants could be a relatively quick and easy step to encourage development of the market.
Proposal #5: Create a public sector longevity bond or mortality index for private-sector bond issuers

- Insurance companies do not have good methods of hedging against the risk that mortality at older ages will fall more rapidly than expected, increasing lifespans and raising the cost of longevity annuity payments.

- Presence of this risk could deter companies from entering the market and/or raise the price of the product

- Two possible responses:
  - U.S. Treasury could issue bonds indexed to aggregate mortality trends
  - A government agency could produce an official mortality index on which private-sector longevity bonds could be based
Conclusion

• Ready access to competitively priced longevity annuities could contribute to the financial security of American retirees

• Have outlined several steps to encourage the development of a robust market for these products

• Look forward to discussion among the panel members