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Better financial security in retirement? Realizing the promise of longevity annuities

Katharine G. Abraham*

* Abraham is Professor of Economics and Survey Methodology at the University of Maryland and a Research Associate of the National Bureau of Economic Research. This brief is based on a paper with the same title co-authored with Benjamin H. Harris, previously Deputy Director at the Retirement Security Project at the Brookings Institution. Support for this publication was generously provided by The Arnold Foundation. Brookings recognizes that the value it provides is in its absolute commitment to quality, independence, and impact. Activities supported by its donors reflect this commitment and the analysis and recommendations are solely determined by the scholar.

Introduction

The U.S. private retirement saving system has undergone a major transformation over the past 25 years. A prolonged shift from defined-benefit to defined-contribution employer plans has given workers more flexibility in how they save for retirement, but also required that they assume greater responsibility for ensuring the adequacy of that saving. In addition, for those at the point of retirement, much of the risk associated with transforming wealth into retirement security has been shifted from retirement plan sponsors to retirees themselves. As a result, retirees increasingly are self-insuring against a variety of retirement risks, especially the risk of outliving their assets.

One option for addressing the risk of extended longevity is to purchase an insurance product known as a "longevity annuity." The essence of a longevity annuity is that it provides a fixed stream of payments that begin with a substantial delay from the time the contract is purchased. A longevity annuity purchased at age 60 or 65, for example, might begin payments at age 75, 80 or 85. Longevity annuities are part of the broader class of "deferred income annuities" (DIAs), which offer annuity payments with a lag of at least one year. While there has been some uptick in the sales of DIAs in recent years, available data indicate that payments under many of these products are scheduled to begin well before late old age and that the current market for true longevity annuities remains very thin.

Although sometimes discussed as financial products, longevity annuities more accurately are characterized as insurance products. A 60-year-old male who purchases a longevity annuity with a 20 year deferral period has only about a 50 percent chance of receiving any payment. The premiums of those who purchase longevity annuities but die before reaching the age of first payment support the payments to those who live to older ages. This risk-pooling design means that longevity annuities may be better structured to address longevity risk than other financial products.

Purchase of a longevity annuity offers an alternative to either financing retirement by spending down invested assets over time or using all of one's assets to buy an immediate annuity at the start of retirement. In the utility framework often favored by economists, the value of longevity annuities is that, at a relatively modest cost, an individual can ensure a reliable source of income even in very old age.

There is a wide gulf, however, between the theoretical benefits offered by longevity annuities and real-world markets. Today's retirees rarely are offered annuities of any sort in their workplace retirement plans, let alone longevity annuities, and few Americans choose to purchase annuities either within or outside their employer-sponsored accounts. The barriers to a more robust market for longevity annuities are diverse, ranging from consumer decision making that does not account adequately for longevity risk to the fiduciary concerns of employers to incomplete markets for the hedging of risk by insurance companies.

Recent changes in policy have taken welcome steps towards bolstering the market for longevity annuities. Most importantly, Treasury regulations released in July 2014 implement a partial exemption from the usual required minimum distribution (RMD) rules that guide the gradual drawdown of retirement assets beginning no later than age 70 years and six months. These regulations exempt the lesser of $125,000 (indexed to inflation) or 25 percent of an account balance from the RMD rules if the distribution is used to purchase a longevity annuity. The new Treasury regulations may have two beneficial effects—they can be expected not only to increase demand for longevity annuities but also to permit annuity purchasers to elect a longer deferral period.

While these changes are welcome, significant barriers to the development of the market for longevity annuities remain. This policy brief discusses the barriers that inhibit consumer participation, employer participation and insurance company participation in the market for longevity annuities and steps that policy makers could take to lower these barriers.

Addressing Obstacles to Consumer Participation

Lackluster consumer interest in longevity annuities has its roots in many factors, some specific to longevity annuities and others related to annuities more generally. One barrier specific to longevity annuities may be simply that individuals do not fully understand the longevity risk they face. Data from an ongoing survey that tracks people over time provide insights into whether individuals are able to predict their own mortality. When first interviewed in 1992 at age 51-61, participants in this survey were asked the probability that they would live to age 75. Among those in the original sample who were old enough that it was known by 2010 whether they in fact had lived to that age, actual survival rates exceeded the anticipated probability of survival, sometimes by a wide margin. At the extreme, roughly half of those who

predicted that they had no chance of living to 75 actually did. Even among the groups who thought they had a 40 percent or 50 percent chance of living to age 75, the share actually surviving to that age was considerably larger (69 percent and 75 percent, respectively). A person who underestimates the chance of having an extended lifespan will be less likely to find a longevity annuity attractive.

Table 1. Actual Survival to Age 75 by Response to Question About Mortality Expectations Asked in 1992 of Individuals Aged 58 to 61

Subjective Probability of Living to Age 75	Actual Probability of Living to Age 75	Unweighted Sample Size
0	49.2	218
10	59.9	65
20	64.6	107
30	71.2	130
40	68.9	110
50	75.1	702
60	78.4	168
70	80.9	284
80	80.1	434
90	82.5	222
100	78.2	664

Source: Authors' calculations using Health and Retirement Study data.

Note: Weighted tabulations of responses to question about subjective mortality asked in 1992 and actual survival to age 75, respondents born from 1931 through 1934.

The lack of demand for longevity annuities can be related to the more general puzzle about why more people do not annuitize at least a portion of their wealth at retirement (Benartzi, Previtero and Thaler 2011). Factors that may play a role include, among other potential explanations, the fact that a person may already have a significant amount of their wealth annuitized in Social Security or employer-provided pensions (Dushi and Webb 2004); framing of annuities as investment products rather than insurance products (Brown, Kling, Mullainathan and Wrobel 2008); adverse selection that makes the expected present discounted value of payouts unattractive for the typical individual (Mitchell, Poterba, Warshawsky and Brown 1999); and the desire to leave a bequest (Lockwood 2012).

Consumers who rely on advice from financial counselors may be especially unlikely to purchase such products. One recent study found that financial advisers systematically deviate from optimal portfolio theory by reinforcing client biases, namely by chasing fund returns and overinvesting in own-company stock, and overwhelmingly recommend actively managed funds over index funds (Mullainathan, Noeth and Schoar 2012). Another study found that clients of fund managers with opaque compensation (for example, commission bundling, where costs are blended with broker fees and not explicitly shown as an expense) experience lower net returns than clients of fund managers with transparent costs (for example, expensed costs) (Edelen, Evans and Kadlec 2012). With respect to longevity annuities, the concern is that advisors who are compensated as an annual percentage of managed wealth will be reluctant to recommend the purchase of lifetime income products that diminish the base on which their compensation is determined.

Concern about the long-run viability of life insurance companies is another factor that often is cited as an impediment to consumer demand for a product whose benefits are not realized for many years. Especially in the wake of the financial crisis, consumers may be influenced by fear that an insurance company will fail to fulfill its obligations to purchasers of annuities contracts. For example, one post-recession survey found that 73 percent of workers and 56 percent of retirees cited concerns over financial stability of insurance companies as a reason to avoid annuities (Figueiredo and Mackenzie 2012). Consumer fears about life insurance insolvencies in the wake of the financial crisis are not justified by actual experience. In fact, due in part to the actions of state and federal regulators, life insurance companies generally weathered the financial crisis without substantial disruption (Government Accountability Office 2013).

If nothing else, these factors suggest a role for public policy to help bridge the information gap and better inform consumers about the potential benefits of longevity annuities as part of a more comprehensive financial plan. One constructive step could be a set of government guidelines aimed at helping older Americans make sound financial decisions. This could be accomplished by the issuance of a financial security graphic, similar to the MyPlate graphic for nutrition (formerly the food pyramid) (Gale and Harris 2013). An effective graphic could point individuals towards potentially useful financial and insurance products, including longevity annuities as well as reverse mortgages, supplemental health insurance, and long-term care insurance. In the interest of credibility, the graphic should be created and disseminated by a reputable, unbiased government agency with notable expertise in financial matters, such as the Office for Older Americans within the Consumer Financial Protection Bureau.

A related strategy would be to find a way to certify financial products—including longevity annuities—that meet established standards for reliability, cost, and quality. While there are some obvious issues around determining who would do this and what procedures they would follow, product certification would have the great

benefit of simplifying consumers' efforts to evaluate the quality of financial products they are considering for purchase. For example, longevity annuities could be certified based on the financial stability of the issuing institution and expected benefits to purchasers relative to the premiums. Moreover, consumers aiming to achieve the recommendations offered by the financial graphic could look to certification as a straightforward guide for purchasing those products deemed to be in compliance. Going further, the federal government could strengthen the power of certification by extending preferential tax treatment only to those products that meet certification guidelines (Hackethal and Inderst 2013).

Revisiting state-level restrictions on what insurance companies are permitted to say in their advertising to prospective customers about the coverage provided by state guaranty associations also could be helpful for addressing consumer fears about life insurance company insolvencies. All states (and the District of Columbia) have a guaranty association whose members are the insurance companies operating in the state. The members agree that, if an insurer operating in the state should fail, other members will contribute funds up to a defined ceiling to pay covered benefits to customers in that state. The existence of these guaranty funds, however, is not something consumers necessarily know about. Our recent review of the relevant state statutes found that the laws of 48 states and the District of Columbia prohibited insurers from advertising the guaranty fund in marketing their products (the two states that did not have a no-advertising rule were Alabama and Michigan). State-level regulations could be amended to allow insurance companies to cite the guaranty association coverage in their marketing materials so long as the limitations of that coverage also are described.

Addressing Obstacles to Employer Participation

The lack of annuity options generally and longevity annuity options specifically in employer retirement plans undoubtedly also has been a major impediment to the development of the market for longevity annuities. According to the Bureau of Labor Statistics, in 2012 only about 17 percent of private-sector workers in savings and thrift plans (the most common type of defined contribution plan) even had an annuity option. Moreover, so far as I am aware, no U.S. employer currently offers a longevity annuity option as part of their defined contribution retirement plan.

The reasons why employers do not offer annuities in their defined contribution accounts are diverse and difficult to quantify, but an important factor appears to be concern about the fiduciary responsibility associated with offering financial products purchased from life insurance companies. In the early 1990s, policymakers put in place strict fiduciary standards designed to protect the benefits promised to participants in defined benefit plans. The Department of Labor (DOL) subsequently promulgated "safe harbor" rules related to the selection of annuity providers by plan sponsors. DOL clarified these rules in August 2015, affirming that the responsibility of a plan sponsor to monitor the finances of an insurer ends at the point when the insurer's annuity product no longer is offered as part of the employer plan. I would argue, however, that the safe harbor nonetheless requires employers to make assessments that are beyond their reasonable capacity. To qualify for safe harbor protection, employers must conclude "at the time of selection that the annuity provider is financially able to make all future payments under the annuity contract" and continue to ensure that the annuity provider meets this standard so long as its product is offered. Employer concern over the requirement that they take responsibility for evaluating the long term financial health of any prospective annuity provider is seen by many annuities industry players as a major impediment to the inclusion of annuities generally and longevity annuities specifically as an option in employer-sponsored defined contribution retirement plans (U.S. Department of Labor 2012).

Ultimately, it seems unreasonable to ask plan sponsors, especially small employers, to independently verify the financial soundness of a life insurance company. Clearly, the role of fiduciary is important and worth safeguarding, but a safe harbor that effectively prevents most retirement plan participants from having an annuity option goes too far. One sensible option would be to revise the problematic portion of the DOL safe harbor by offering a more transparent, easily verifiable test.

The American Council of Life Insurers (ACLI) has advanced a policy proposal that would retain the spirit of the DOL safe harbor while easing the fiduciary burden on plan sponsors. The key proposed requirement is that any company selected as an annuity provider be licensed to offer guaranteed income products in at least 26 states. The insurer also would be required to provide written representation that it has a clean certificate of authority from the insurance commissioner in its home state; that it has filed appropriate audited financial statements in its home state; that it maintains legally required reserves; and that it is not operating under an order of supervision, rehabilitation or liquidation. Further, the insurer would be required to undergo a financial examination in its

home state at least once every five years (Barry 2013). While there are limitations to any regulatory scheme, state insurance commissioners—with substantial expertise in this area—are surely far better prepared than individual plan sponsors to assess the financial health of an insurance company.

If the specific option proposed by the ACLI is unattractive, another option might be to use a company's attainment of a specified threshold on the Insurance Financial Strength Rating employed by ratings agencies. This rating, which is based in part on assessments of risk-based capital, is uniquely designed to measure the ability of insurance companies to meet their financial obligations.

An additional step that could help to jump-start the market for longevity annuities would be to offer them within the federal Thrift Savings Plan (TSP). The TSP is an enormous defined contribution plan for federal workers that, as of 2012, covered 4.6 million participants and contained over $300 billion in assets spread across five major investment funds. Current TSP participants can take their distributions as a lump-sum, as an immediate annuity (provided by Metlife), as periodic withdrawals from the account, or as a combination lump-sum payment and annuity or gradual withdrawal (Isaacs 2013). To encourage take-up of longevity annuities, TSP participants could be offered a longevity annuity as a distribution option, either alone or combined with a lump-sum distribution and/or periodic withdrawals. As with the immediate annuity option, the longevity annuity would be provided by a private insurance company.

Addressing Obstacles to Insurance Company Participation

A concern for insurers who are contemplating entrance to the market for longevity annuities is uncertainty about mortality rates twenty or more years in the future. A company that guesses wrong and finds that people are living longer than it had expected could face a significant unplanned liability. While other types of risk typically can be mitigated through various hedging strategies—for example, inflation risk can be hedged through purchase of inflation-indexed government securities—there exists no practical mechanism for hedging effectively against aggregate mortality risk.

It might seem that life insurers should be able to hedge against aggregate mortality risk by issuing offsetting annuity and life insurance contracts. Such a strategy is not particularly effective, however, because gains in aggregate mortality are likely to be realized mainly by those at the oldest ages, while life insurance risk is spread throughout the adult age distribution (Blake and Burrows 2001). Other options, such as spreading risk across countries or generations, can partially mitigate the mortality risk that insurance companies face, but no private strategy can entirely address it (Brown and Orszag 2006). Public-sector entities are in a unique position to provide hedges against aggregate mortality risk.

One option would be for the U.S. Treasury to issue bonds indexed to aggregate mortality trends. As with inflation-indexed bonds, access to such bonds for hedging purposes would allow insurers to focus on pooling idiosyncratic risk, rather than taking on risk related to macroeconomic and demographic trends. The basic premise of this bond would be that the coupon payment would be tied to aggregate mortality trends for a specific group of individuals, such as individuals of a particular age or cohort. Insurers then could purchase these bonds in conjunction with their age-based liabilities. If lower aggregate mortality for the group (i.e., an increase in life span) were realized, the coupon payments from the longevity bond would rise to offset the higher payments due to annuitants in the group. In effect, a mortality-indexed bond would transfer risk from life insurance companies onto the future taxpayers who would be liable for the payments on the bonds.

A complementary reform would be for a government agency to produce official mortality indices on which private-sector longevity bonds could be based. For example, an agency such as the Social Security Administration could calculate and publish longevity indices for given age groups. Such indices could be a useful tool in pricing and benchmarking longevity bonds, whether or not those bonds were issued by a public-sector entity.

Conclusions

As employers have replaced defined benefit pensions with account-based retirement plans, defined-contribution wealth has soared into the trillions of dollars. This build-up in liquid retirement wealth, however, has not been accompanied by development of the capacity and access to appropriate financial tools that would best enable American households to use those assets to achieve their desired degree of retirement security. This policy brief has explored reasons why a robust market for longevity annuities has yet to develop despite their theoretical appeal and outlined policy reforms aimed at consumers, employers and insurers that could provide better support for this nascent market, helping to turn longevity annuities into a mainstream product for retirees.

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