RETIREMENT INCOME INSTITUTE

Alliance for Lifetime Income

Who Should Read This Insight:
Policymakers, annuity makers, finance professionals, academics

Institute Research Agenda Topic:
New takes on the annuity puzzle.

POLICIES TO INCREASE THE POPULARITY OF LIFETIME ANNUITIES

Definitions of **bold key terms** are at the end of this article.

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Authors, Titles and Publication Dates of the Articles Addressed in the Insight

Rami Hanegbi. 2013. "Security in Uncertain Times: Policies for Increasing the Popularity of Life Annuities Among Retirees." Virginia Journal of Social Policy and the Law 20: 467–509.

IDEAS IN THIS INSIGHT YOU CAN PUT INTO ACTION

Policymakers can aim to emulate some of the salient characteristics of high-annuity markets into more-widespread annuity markets. Specifically, laws that facilitate and encourage retirement plans to directly offer lifetime annuities, the presence of a more comprehensive and universal annuity guarantee system, and laws that encourage the framing of annuities in a positive manner, can operate synergistically to improve annuitization rates.

PRINCIPAL INSIGHTS

Although **lifetime annuities** offer a secure income stream that is to a large degree free from investment risk, **longevity risk**, and—in some cases—inflation risk, **annuitization** rates continue to be low, a phenomenon known as the **annuity puzzle**. Some of the reasons for this phenomenon—such as **bequest motives**, potential for other investment opportunities, and the desire for liquidity—are due to the inherent nature of lifetime annuities and the environment they operate in. However, policymakers can, to some degree, abate the effect of some other reasons for low annuitization rates. These other reasons include relatively high **annuity** prices, which are partially attributable to **adverse selection**; the presence of **behavioral biases**; and the way annuities are **framed**. Specifically, adverse selection in the life annuity markets manifests itself through those perceiving themselves as having higher-than-normal longevity being more likely to purchase life annuities. This has the effect of increasing annuity prices, which then causes potential annuity purchasers to become even more skewed toward individuals who expect to live a long life, which then contributes to a spiral leading to even higher annuity prices.

People tend to be more concerned about preventing the loss of wealth than they are about gaining more wealth, and have a tendency to place too much emphasis on small risks and to discount high risks. These human biases negatively affect annuity demand due to comparatively minor risks that are inherent in annuities—such as the risk of a significantly early death and the subsequent loss of funds that had been invested in the annuity, or of the provider defaulting on annuity payments. **Retirement investors** who would otherwise be in the annuity market tend to give a disproportionate amount of weight to these risks.

This article examines markets that, at the time of the study, were characterized by high annuitization rates, and finds that those markets had a few common traits. Specifically, those markets were characterized by relatively inexpensive annuities and were less affected by behavioral biases than were markets that had low annuitization rates. In addition, annuities in markets with inexpensive annuities were framed in a comparatively attractive way. Specifically, behavioral biases were less likely to be an issue in high-annuitization markets because employer-sponsored plans typically offer lifetime annuities directly to their participants, who in many cases have been associated with the plans for a long time. These factors

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resulted in a more trusting relationship and, more importantly, resulted in participants who have a strong tendency to view lifetime annuities as a collective arrangement that could benefit both themselves and their coworkers. In contrast, when an individual purchases an annuity from an insurance company, he or she is more likely to perceive the prospect of an early death as the loss of an unfair bet, with the winner being the insurance company and its executives and shareholders. With regard to framing, in high-annuitization markets the participant benefit statements, which stated the balance of plan members, were more likely to include, and in some cases to emphasize, the member's expected annuity entitlements.

The article identifies the most important characteristics of high-annuitization markets, then suggests policy reform aimed at increasing annuitization rates. It first suggests policies that strongly encourage retirement plans that directly offer lifetime annuities to their participants. Such policies include making it easier for retirement plans to encourage the purchase of annuities by modifying the **safe harbor provisions** and the required minimum distribution rules. Since the article was published, this plan has to some extent been implemented. Specifically, qualified **longevity annuity** contracts are now exempted from the required minimum distribution rules. Specifically, when the required minimum distribution rules apply, a certain percentage of the account balance must be withdrawn annually to avoid adverse tax consequences. This is ill-suited to deferred life annuities, where there are typically no payments for a number of years. Furthermore, the recent SECURE Act has modified the safe harbor provision available to retirement plan **fiduciaries** when choosing an annuity provider to purchase annuities from (which are then offered to their members). Importantly, the article notes that policymakers need to go beyond removing such impediments and to pursue the means to actively encourage retirement plans that offer lifetime annuities.

Second, the article suggests that policymakers should encourage funds to frame annuities in a more attractive manner, such as through enacting laws that incentivize participant statements to include what their benefits are—not only in the form of a lump sum, but in the form of an annuity as well. It is worth noting that, since the publication of this article in 2013, the recent SECURE Act partially implemented this policy by requiring that, for any given 12-month period, retirement plan statements include a lifetime income disclosure. Third, the article recommends that policymakers should consider replacing the state-level guarantees, which are administered by a different body for each state (resulting in no consistency among states regarding the maximum guarantee amounts applying to individual cases of annuity default) with a comprehensive federal guarantee scheme; that scheme would be administered by the federal government and could have a universal, relatively generous maximum guarantee amount. Ideally, such a federal scheme would have a maximum coverage amount that is substantially higher than the current modest level of many of the state-level schemes.

The article not only argues that each of these policies would directly increase annuity demand, but also that increasing that demand would decrease the adverse selection effect and so lead to a positive feedback loop of less-expensive annuities and so further increase annuity demand. The author proposes that the suggested means of making annuities more attractive, leading to higher annuitization rates, have advantages over the use of subsidies, which can potentially be inequitable and can cause market distortions. Furthermore, such means of increasing annuitization rates also have advantages over mandating annuities, or using nudges such as mandating or encouraging annuitization as the default choice from which participants can opt out. This is because these latter policy options involve, to varying degrees, the loss of freedom. Also, although there is evidence of market imperfections in the annuitization market, it does not necessarily follow that the majority of people would benefit from paternalistic policies.

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KEY TERMS ARE SOURCED FROM THE ALLIANCE FOR LIFETIME INCOME'S ANNUITIES LANGUAGE GLOSSARY AND INVESTOPEDIA

adverse selection: *A market situation where buyers and sellers have asymmetrical information, leading to markets operating sub-optimally and even failing.*

annuitization: *The process of converting an investment into a series of periodic income payments by buying an annuity or beginning an income flow from an annuity.*

annuity: *A financial product that can offer protected lifetime income and even potentially grow your money.*

annuity puzzle: *The annuity puzzle refers to the fact that few people choose to annuitize even a portion of their accumulated savings even though they have many good and rational reasons to do so.*

behavioral bias: *An illogical preference or prejudice that is a natural human foible that can cloud the judgment of a person deciding on an action.*

bequest motive: *A bequest motive is an owner's desire to give assets such as stocks, annuities, bonds, jewelry, and cash to individuals or organizations, through the provisions of a will or an estate plan. Bequests can be made to family members, friends, institutions, or charities.*

fiduciary: *A qualified financial professional who is required to help you make financial decisions in your best interest. A fiduciary is not the only type of financial professional required to help you make financial decisions in your best interest. Certain non-fiduciaries must also comply with best-interest requirements.*

frame, framing: *Framing is how financial products are presented to consumers.*

lifetime annuity: *A lifetime annuity is an investment vehicle that functions as a personal pension plan. Sometimes referred to as "single life," "straight life," or "non-refund," these are a form of immediate annuity that provides income for your entire life. The payments can be increased to cover a second person. This is called a "Joint and Survivor" annuity. While most provide income for life, some may offer the option of payments for a fixed number of years.*

longevity annuity: *Annuity with delayed payments starting in the future.*

longevity risk: *The chance that you may live longer than your income will last.*

retirement investor: *Someone who invests his or her own retirement savings, regardless of type.*

safe harbor provision: *A legal provision in a statute or regulation that provides protection from a legal liability or other penalty when certain conditions are met.*

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