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Removing the legal impediments to offering lifetime annuities in U.S. pension plans

Jonathan Barry FORMAN[1]
University of Oklahoma, College of Law

Abstract. Longevity risk – the risk of outliving one's retirement savings – is probably the greatest risk facing current and future retirees in the United States. At present, for example, a 65-year-old man has a 50% chance of living to age 82 and a 20% chance of living to age 89, and a 65-year-old woman has a 50% chance of living to age 85 and a 20% chance of living to age 92. The joint life expectancy of a 65-year-old couple is even more remarkable: there is a 50% chance that at least one 65-year-old spouse will live to age 88 and a 30% chance that at least one will live to 92. In short, many individuals and couples will need to plan for the possibility of retirements that can last for 30 years or more.
One of the best ways to protect against longevity risk is by securing a stream of lifetime income with a traditional defined benefit pension plan or a lifetime annuity. Over the years, however, there has been a decided shift away from traditional pensions and towards defined contribution plans that typically distribute benefits in the form of lump sum distributions rather than as lifetime annuities, and people rarely buy annuities in the retail annuity market. All in all, Americans will have longer and longer retirements, yet fewer and fewer retirees will have secure, lifetime income streams. This article considers how changes in the laws and regulations governing pensions and annuities could help promote greater annuitization of retirement savings.

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1. Introduction

Longevity risk – the risk of outliving one's retirement savings – is probably the greatest risk facing current and future retirees in the United States [Oakley 2015; Park 2011]. At present, for example, a 65-year-old man has a 50% chance of living

[1] Contact with author: Jonathan Barry Forman, Alfred P. Murrah Professor of Law, University of Oklahoma, College of Law, 300 Timberdell Road, Norman Oklahoma, 73019, USA, e-mail: jforman@ou.edu. The research reported herein was performed pursuant to a grant from the TIAA Institute through the Pension Research Council/Boettner Center of the Wharton School of the University of Pennsylvania (PRC). The findings and conclusions expressed are solely those of the author and do not represent the views of the PRC or TIAA. This article is based on a presentation at the International Scientific Conference on Security, Responsibility and Property of Pensions held at the University of Gdansk in cooperation with The European Network for Research on Supplementary Pensions, Sopot, Poland, Sept. 8–9, 2016. For a longer version of this Article, see Forman (2016).

to age 82 and a 20 percent chance of living to age 89, and a 65-year-old woman has a 50% chance of living to age 85 and a 20% chance of living to age 92.[2] The joint life expectancy of a 65-year-old couple is even more remarkable: there is a 50% chance that at least one 65-year-old spouse will live to age 88 and a 30% chance that at least one will live to 92. In short, many individuals and couples will need to plan for the possibility of retirements that can last for 30 years or more. There were 48.6 million retirees in the United States in 2014, but there are expected to be 66.4 million retirees in 2025 and 82.1 million in 2040 [Kerzner 2015].

One of the best ways to protect against longevity risk is by securing a stream of lifetime income with a traditional defined benefit pension plan or a lifetime annuity. Over the years, however, there has been a decided shift away from traditional pensions and towards defined contribution plans that typically distribute benefits in the form of lump sum distributions rather than as lifetime annuities [U.S. Department of Labor, Employee Benefits Security Administration 2013], and people rarely buy annuities in the retail annuity market [Benartzi, Previtero, Thaler 2011]. All in all, Americans will have longer and longer retirements, yet fewer and fewer retirees will have secure, lifetime income streams. This Article considers how changes in the laws and regulations governing pensions and annuities could help promote greater annuitization of retirement savings.

2. An overview of lifetime income mechanisms in the United States

2.1. Social security

Elderly Americans can generally count on Social Security benefits to cover at least a portion of their retirement income needs. For example, in January of 2017, Social Security paid retirement benefits to more than 41.3 million retired workers, and the average monthly benefit paid to a retired worker was $1362.64 [Social Security Administration 2017a]. Another 2.2 million elderly Americans received means-tested Supplemental Security Income (SSI) benefits from the federal government, and the average monthly benefit was $438.26. Sixty-one percent of elderly Americans receive at least half of their income from Social Security [Social Security Administration 2016].

2.2. Pension plans, individual retirement accounts, and annuities

The United States has a "voluntary" pension system, and retirement savings may be inadequate for many retirees [U.S. Government Accountability Office (GAO) 2015c; Forman, Sandy Mackenzie 2013]. At any point in time, only about half of American

[2] Calculations are from the Society of Actuaries, *Life Expectancy Calculator* (2017), https://www.soa.org/Files/Xls/research-life-expect-calc.xls (based on the Social Security Administration's 2010 mortality tables for the general U.S. population; an individual's life expectancy is the average number of years until death).

workers have a pension;[3] and participation in *individual retirement accounts* (IRAs) is even lower.[4] Most pension plans qualify for favorable tax treatment [Staff of the Joint Committee on Taxation 2016]. Employer contributions to a pension are not taxable to the employee; the pension fund's earnings on those contributions are tax-exempt; and employees pay tax only when they receive distributions of their pension benefits. Nevertheless, employers are generally allowed to deduct their contributions.

In a *defined benefit plan*, an employer promises employees a specific benefit at retirement. For example, a plan might provide that a worker's annual retirement benefit (B) is equal to 2% times the number of years of service (yos) times final average compensation (fac) ($B = 2\% \times yos \times fac$). Under this traditional, final-average-pay formula, a worker who retires after 30 years of service with final average compensation of $50,000 would receive a pension of $30,000 per year for life ($30,000 = 2% × 30 *yos* × $50,000 *fac*). The default benefit for defined benefit plans is a retirement income stream in the form of an annuity for life.[5] While many defined benefit plans allow for lump sum distributions, most retirees receive lifetime annuities. For example, according to the U.S. Government Accountability Office, 67.8% of workers who retired with a defined benefit pension from 2000 through 2006 took the defined benefit plan annuity [GAO 2011, p. 26].

Under a typical *defined contribution plan*, the employer simply withholds a specified percentage of the worker's compensation, which it contributes to an individual investment account for the worker. For example, contributions might be set at 10% of annual compensation. Under such a plan, a worker who earned $50,000 in a given year would have $5,000 contributed to an individual investment account ($5,000 = 10% × $50,000).[6] Unlike defined benefit plans, defined contribution plans usually make distributions as lump sum or periodic distributions rather than as lifetime annuities. For example, in 2010, just 18% of private industry workers in defined contribution plans had annuities available to them [U.S. Department of Labor, Bureau of Labor Statistics 2011, table 21; GAO 2011].

Over the past few decades, there has been a major shift from traditional defined benefit plans to defined contribution plans [Staff of the Joint Committee on Taxation 2016, pp. 56-57; Mackenzie 2010]. For example, just 20% of *Fortune 500* com-

[3] For example, in March of 2016, 66% of private-sector workers had access to a pension plan, and 49% of them participated (U.S. Department of Labor, Bureau of Labor Statistics, 2016, p. 5 table 1).

[4] For example, while 32% of U.S. households had an IRA in 2015, only around 14% of households made contributions to their IRAs (in 2014) (Holden & Schrass 2016, pp. 2, 19).

[5] While insurance companies can typically price the annuities that they offer to men and women differently, pension plans in the United States cannot offer different pricing based on gender. Pension plans cannot require higher contributions from women or pay women lower benefits. Therefore, when an employee retires with a traditional defined benefit pension, the retiree will see the same monthly pension benefits for life, regardless of gender. For example, see Forman and Sabin 2015, pp. 823-824 (explaining how the Civil Rights Act of 1964 prohibits gender discrimination by pensions).

[6] Tax-favored *401(k) plans* are the most popular type of defined contribution plan in the United States today [U.S. Department of Labor, Bureau of Labor Statistics 2010]. These plans generally allow individuals to tax-shelter up to $18,000 in 2017 [Internal Revenue Service 2016].

panies offered salaried employees a defined benefit plan in 2015, down from 59% in 1998 [McFarland 2016].

Favorable tax rules are also available for IRAs.[7] Like private pensions, IRA earnings are tax-exempt, and distributions are taxable.

The federal income tax system also provides favorable tax treatment of investments in annuities. Although the value of an annuity investment grows over time, no tax is imposed until annuity distributions begin.

3. The role for annuities and other lifetime income mechanisms

With the disappearance of traditional defined benefit pension plans, American workers now have the primary responsibility to participate in, contribute to, and manage their retirement savings accounts throughout their working years; and they must also manage all of their retirement savings throughout their retirement years. These are daunting tasks [Perun 2010]. To have adequate income throughout retirement, individuals need to make wise choices about when to retire, when to claim Social Security benefits, how to plan for an unknown length of retirement, how to plan for medical expenses and long-term care, how to use a home to provide retirement income, how to manage a retirement savings portfolio, and how to convert accumulated retirement savings into a lifetime income stream [American Academy of Actuaries 2015a].

That is where traditional pensions, annuities, and similar lifetime income products come in. Unfortunately, people rarely choose to buy annuities voluntarily. The demand for annuities is significantly lower than expected, and this shortfall has come to be known as the "annuity puzzle" [Benartzi, Previtero, Thaler 2011]. Some of the reasons for the low demand for annuities include: the existence of alternative annuities such as Social Security, Supplemental Security Income, and traditional defined benefit plans; a willingness to rely on phased distributions from defined contribution plans, IRAs, and other retirement savings; the desire to leave bequests; the incompleteness or inefficiencies in the retail annuity market that lead to poor prices for retail annuities; and the behavioral and cultural challenges involved in getting individuals to make decisions about complex investments like annuities [Holzmann 2015]. There are also constraints on the supply of lifetime annuities, including inefficient regulation of annuity markets and the limited availability of inflation-adjusted and longevity assets that can be matched against insurer annuity-related liabilities.[8]

It turns out that the demand for lifetime annuities is consistently low in most of the world, although there are a few notable exceptions [Rocha, Vittas, Ru-

[7] In 2017, individuals can contribute and deduct up to $5500 to an IRA [Internal Revenue Service 2016].

[8] There is not yet much of a market in longevity bonds—bonds that would pay returns that would be linked to the survivorship of a given cohort, say, 65-year-old American males born in 1952 [Holzmann 2015, pp. 11-18; Antolin, Blommestein 2007; Blake, Boardman, Cairns 2010].

dolph 2011; Holzmann 2015]. The gold standard is probably the Netherlands, where benefits from occupational pensions must be paid out in the form of an inflation-adjusted annuity to qualify for tax benefits [Turner, Rhee 2013]. In many countries, however, participants can choose among lump sum distributions, phased withdrawals, and annuities, just as they often can in the United States. Experiences vary, but there are at least a few countries where participants generally select annuitization. For example, in Switzerland around 80% of retirement savings accumulations are converted to lifetime annuities [Holzmann 2015; Bütler, Teppa 2007]; and in Chile, 70% of retirees choose lifetime annuitization of their public pension benefits over the phased-withdrawal alternative [Holzmann 2015]. On the other hand, annuitization in Australia is extremely rare [Agnew 2013]. The United Kingdom used to have high levels of annuitization, but it has recently moved away from requiring retirees to purchase annuities [HM Revenue & Customs 2016].

4. Options for reform

This Part offers a variety of possible legislative and regulatory changes that could encourage greater annuitization of retirement savings. In that regard, however, policymakers need to bear in mind that some policies to encourage greater annuitization might have undesirable distributional consequences.[9]

4.1. Increase and preserve retirement savings

4.1.1. Encourage workers to save more for retirement

At the outset, government policies could be designed to encourage workers to save more for retirement. If workers saved more during their careers, they would have larger nest eggs at retirement and a greater ability to buy annuities and other lifetime income products. Perhaps, the best way to increase retirement savings would be for the United States to adopt a mandatory universal pension system like Australia, Singapore, and Chile have done [Forman, Gordon Mackenzie 2013; GAO 2009, pp. 20-26; Ghilarducci 2008].

A less intrusive federal mandate would be to require employers without plans to at least offer automatic payroll-deduction IRAs to their employees [U.S. Department of Treasury 2016a, pp. 134-137; GAO 2013b; Iwry, John 2009]. The United Kingdom's new National Employment Savings Trust (NEST) program is an example of this type of mandate [Sass 2014]. U.S. former President Barack Obama's Administration rolled out no-fee retirement savings accounts known as "myRAs," short for "My Retirement Account" [U.S. Department of Treasury 2016b]. A number of state governments in the United States are also considering requiring employers to

[9] Life expectancy varies with such demographic factors as gender, income, educational level, and race and Hispanic origin [U.S. Department of Health & Human Services, Centers for Disease Control and Prevention, National Center for Health Statistics 2017; Forman 2014).

at least offer pension plans to their uncovered workers [GAO 2015b]. Congress and the Obama Administration also recommended amending the Employee Retirement Income Security Act of 1974 (ERISA) to permit unaffiliated employers to join multiple-employer plans (MEPs) [U.S. Department of the Treasury 2016a, pp. 147-149; Staff of the Joint Committee on Taxation 2016, pp. 65-71]. In general, automatically enrolling workers into these types of individual retirement savings accounts should achieve higher levels of participation [OECD 2012, pp. 45-76; VanDerhei 2012]. Automatic enrollment and similar behavioral economics nudges are not likely to solve the problem of inadequate retirement savings, but they can help.

4.1.2. Help participants earn better returns on their retirement savings

In addition to getting workers to save more, government policies could encourage workers to make wiser investment choices. In that regard, the qualified default investment alternatives (QDIA) regulations have already helped move millions of participants away from low-yield, stable-value bond funds and towards better-diversified investments like target-date funds [Bary 2014]. The U.S. Department of Labor could clarify those QDIA regulations and also make it easier for plan sponsors to include annuities in their line-up of QDIA investment alternatives [GAO 2015a]. The government could also do a better job of regulating the fees and expenses associated with retirement plans. In that regard, high fees can significantly reduce the size of retirement nest eggs [Forman 2007; Collins, Holden, Duvall, Barone 2016].

4.1.3. Encourage workers to work longer

The government could also encourage workers to remain in the workforce longer [Forman 2014; American Academy of Actuaries 2013; Munnell, Orlova, Webb 2012]. For example, because Social Security provides actuarial increases in benefits to those who delay taking their benefits, the government could encourage people to delay taking their benefits until they reach their full retirement age or, better still, until age 70 [Tacchino, Littrell, Schobel 2012].

For that matter, the government could increase all of the statutory ages associated with retirement. For example, the 10% early distribution penalty on premature withdrawals applies only to distributions made before an individual reaches age 59½, and the early retirement age for Social Security is age 62. It could make sense to increase both early retirement ages to 65. It could also make sense to increase both the normal retirement age for Social Security (currently age 66 but gradually increasing to age 67), and the normal retirement age for pensions (typically age 65) to age 70 [Social Security Administration 2017b; Internal Revenue Code § 411(a)(8); ERISA § 3(24), 29 U.S. Code § 1002(24)]. Finally, it could make sense to increase both the delayed retirement age for Social Security (currently age 70) and the required minimum distribution age for pensions (age 70½) to age 75 or beyond.

4.1.4. Preserve benefits until retirement

Government policies could also be designed to get workers to preserve their retirement savings until retirement, for example, by discouraging premature pension withdrawals and loans [Forman, Gordon Mackenzie 2013; Orlova, Rutledge, Wu 2015]. While defined benefit plans typically provide lifetime annuities for retirees and their spouses, defined contribution plans are leaky: they often allow participants to withdraw all or a portion of their individual accounts, and many plans allow participants to borrow against their accounts.

4.2. The Government could promote annuitization

There is a variety of other ways that the government could promote annuitization. One approach would be for the government to mandate that retirees use at least a portion of their retirement savings to purchase annuities or similar lifetime income guarantees [Mackenzie 2010, pp. 191-200; Perun 2010; Brown 2009].

Alternatively, the government might only want to encourage annuitization. For example, the government could require plan sponsors to include annuities or other lifetime income mechanisms in their investment options and/or in their distribution options [GAO 2011; Kennedy 2013]. The government might also encourage pension plans to offer beneficiaries more flexibility, for example, by offering partial annuitization options and not just all-or-nothing annuitization choices [Beshears, Choi, Laibson, Madrian, Zeldes 2014]. The government might even require plans to default participants into annuities or trial annuities, unless plan participants affirmatively elect otherwise [Mackenzie 2010, pp. 200-203; Iwry, Turner 2009; Gale, Iwry, John, Walker 2008].

The federal government could also provide additional tax benefits for individuals who receive income from lifetime annuities and lifetime pensions, for example, by completely exempting lifetime income payments from income taxation or favoring them with a reduced tax rate. Policymakers could, of course, target the benefit towards less affluent retirees by limiting the preferential rates to, say, no more than $30,000 a year of annuity or pension income per retiree.

The federal government could even enter into the market of selling annuities. The Social Security system implicitly allows workers to buy actuarially fair lifetime annuities merely by delaying retirement beyond age 62, but the government might also let individuals and couples buy a limited amount of explicit inflation-adjusted lifetime annuities – perhaps enough to keep them out of poverty throughout their retirement years.[10] Alternatively, the federal government could guarantee annuities sold by private companies.

[10] In 2017, the poverty level for a single individual is $12,060, and the poverty level for a married couple is $16,240 [U.S. Department of Health and Human Services, Office of the Assistant Secretary for Planning and Evaluation 2017].

In any event, the government could make it easier for plan sponsors to offer annuities and deferred income annuities (a/k/a longevity insurance).[11] For example, it might make sense to let plan sponsors rely on insurance regulators and industry standards to oversee and monitor annuity providers. That is the way it works in many other countries [GAO 2013a, pp. 37-39]. For example, the U.S. Department of Labor could post a list of approved annuities and annuity providers that plan sponsors could use.

At the very least, the government could promote better financial education about annuities and other lifetime income options. The U.S. Department of Labor already hosts a *Lifetime Income Calculator* that can be used to estimate monthly pension benefits for a typical retiree [U.S. Department of Labor, Employee Benefits Security Administration 2017]. In addition to the *Lifetime Income Calculator*, the U.S. Department of Labor could provide, or endorse, more extensive calculators. The U.S. Department of Labor could also design, or endorse, an individualized life expectancy calculator to help participants get a better idea of how long they and their spouses can expect to live. To calculate life expectancy, individualized life expectancy calculators typically ask about an individual's age, education, work, smoking habits, exercise regime, and family health [for example, see Foster, Chua, Ungar 2016].

4.3. Improve annuity regulation and markets

4.3.1. Strengthen the market for annuities

The current state-by-state insurance regulatory system is antiquated, costly, and inefficient [Perun 2007]. One way to cut down on regulatory costs might be to allow insurance companies to avoid costly state-by-state regulation by instead electing an optional federal charter. Another approach would be to make the state-based guaranty funds that backstop annuities stronger. A more uniform standard, or even a federal guaranty fund, would be preferable to the current system.

A related problem with retail annuities in the United States is that state laws generally prevent insurance companies from mentioning their state-based guarantees in their sales material [American Academy of Actuaries 2015b; Abraham, Harris 2016]. The no-advertising rule seems to be designed to limit the moral hazard among insurance companies that might occur if insurance companies took greater investment risks because they could rely on the state-based insurance guarantees. We should be concerned about the solvency of insurance companies, allowing insurance companies to advertise their state-based guarantees that would increase consumer confidence in annuities and so encourage more individuals to buy them, and that should make annuity markets more competitive and bring annuity prices down.

[11] The typical approach is to buy a deferred income annuity at age 65 that starts making annual payments only if the annuitant lives past age 80 or 85 [Abraham, Harris 2016; Webb, Gong, Sun 2007; Milevsky 2005).

4.3.2. Broaden the range of permissible lifetime income products

In addition to promoting annuities, it could make sense to broaden the range of permissible lifetime income products. One approach is to develop more products that pool risk among participants, as opposed to products that necessitate high premiums to compensate insurance companies for their guarantees and profits.[12]

In that regard, for example, TIAA's College Retirement Equities Fund (CREF) offers a variety of low-cost variable annuities that pool risk among participants [Forman, Sabin 2015, p. 798; Poterba, Warshawsky 2000]. Participants choose from various funds to invest in; and later on, they choose from among a variety of distribution options, including one-life and two-life annuities. When a retiree selects a lifetime annuity, the annuity payments depend on both the investment experience of the chosen accounts and on the mortality experience of the other participants; but the way that these annuities are designed, the mortality risk falls on the annuitants, and it is not guaranteed by CREF.

There are many other ideas for lifetime income products that could share longevity risk among participants. For example, so-called "defined-ambition plans" – like those in operation in the Netherlands – offer a way to share risk among plan participants [Bovenberg, Mehlkopf, Nijman, 2016; Kortleve 2013]. Also, elsewhere, the author has suggested we could pool risk among participants with so-called "tontine annuities" and "tontine pensions" [Forman, Sabin 2015]. So-called "variable annuity pension plans" are another product that could help promote retirement income security (Camp, Coffing, Preppernau 2014]. Another idea would be to modify ERISA to permit employers to offer longevity plans – supplemental defined benefit plans where participation begins at age 45 or later and benefits commence at age 75 or later [Most, Wadia 2015].

5. Conclusions

Pensions, annuities, and similar lifetime income products provide the best way to protect against longevity risk. Over the years, the responsibility for creating such secure retirement income streams has shifted from employers to individuals. This article showed how changes in the U.S. laws and regulations governing pensions and annuities could help promote secure, lifetime income policies. More specifically, this article showed how the laws governing annuities could be changed to make voluntary annuitization more attractive and how the laws regulating pensions could be changed to incentivize pension plan sponsors to offer more annuity options and to encourage employees to elect those options.

[12] For example, see Donnelly 2015; Donnelly, Guillén, Nielsen 2014; Maurer, Mitchell, Rogalla, Kartashov 2013; Maurer, Rogalla, Siegelin 2013; Donnelly, Guillén, Nielsen 2013; Qiao, Sherris 2013; Brown, Meredith 2012; Richter, Weber 2011; Denuit, Haberman, Renshaw 2011; Rocha, Vittas, Rudolph 2011; Stamos 2008; and Piggott, Valdez, Detzel 2005.

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Eliminacja przeszkód natury prawnej w kwestii renty dożywotniej oferowanej w ramach planów emerytalnych w Stanach Zjednoczonych

Streszczenie. Ryzyko długowieczności, czyli problem życia dłuższego niż okres, na który wystarczą oszczędności emerytalne, jest prawdopodobnie największą bolączką, która dotyka obecnych i przyszłych emerytów w Stanach Zjednoczonych. Współczesny 65-letni mężczyzna z 50% prawdopodobieństwem dożyje 82 lat i z 20% prawdopodobieństwem dożyje 89 lat, zaś 65-letnia kobieta, ma 50% szans na przeżycie 85 lat oraz 20% na dożycie 92 lat. Łączna średnia długość życia 65-letniej pary jest jeszcze bardziej zadziwiająca, z 50% prawdopodobieństwem przynajmniej jeden z partnerów dożyje 88 lat oraz z 30% prawdopodobieństwem jedno z nich dożyje 92 lat. Podsumowując, wiele osób i par będzie potrzebowało planu emerytalnego, oferującego wypłatę świadczenia przez okres 30 lat lub więcej.
Jednym z najlepszych sposobów ochrony przed ryzykiem długowieczności jest zapewnienie dożywotniego strumienia wypłat w ramach tradycyjnego programu o zdefiniowanym świadczeniu lub renty dożywotniej. Przez lata nastąpił odwrót od tradycyjnych planów emerytalnych na rzecz programów o zdefiniowanej składce, które z reguły wypłacają świadczenia w formie jednorazowej a nie w formie renty dożywotniej, zaś świadczeniobiorcy rzadko kupują rentę dożywotnią na rynku detalicznym. Amerykanie będą przebywali z pewnością coraz dłużej na emeryturze, jednak coraz mniej z nich będzie miało stały i bezpieczny, dożywotni dochód. W niniejszym artykule dokonano analizy tego, jak zmiany w ustawach i regulacjach dotyczących emerytur oraz rent dożywotnich mogą pomóc w promowaniu renty dożywotniej jako formy wypłaty oszczędności emerytalnych.

Słowa kluczowe: renta, renta dożywotnia, prawo emerytalne, polityki emerytalne.
Kody JEL: D14, G22, G23, G28, H24, H55, J14, J26, K31, K34.