

In Annuities

Annuity Markets and Pension Reform

BY GEORGE A. (SANDY) MACKENZIE



THE MERITS of using individual accounts to reform Social Security had been intensely debated for some years before the Bush administration tabled its proposal. Some of the best actuarial and economic minds in the country had analyzed the issues raised by adding an individual accounts component to Social Security.

One particularly important issue was the risk Americans would be assuming by investing a chunk of their retirement savings in the stock and bond markets. If, when they retired, financial market performance wasn't up to par, then their accumulated savings would be insufficient for a comfortable retirement. An equally important issue was how individual Social Security accounts would affect national saving habits and economic growth.

The debate over the reform and the research it inspired focused on the accumulation phase of the public pension system, but the distribution phase didn't receive the same attention. (A notable exception was the bipartisan study *Uncharted Waters*, undertaken under the auspices of the National Academy of Social Insurance, which didn't appear until 2005.)

The lack of emphasis on the distribution phase is curious because it raises such critical issues: To begin with, should distributions be restricted at all? Or should Social Security account holders be free to withdraw sums as they choose once they've reached the normal retirement age?

That laissez-faire option could be rejected if the money in the accounts was intended to replace part of the Social Security retirement benefit, because there is general agreement that the Social Security benefit should be a life annuity. Nonetheless, a case might be made for a lump-sum withdrawal of part of the balance, depending on its size and the account holder's circumstances.

Other basic issues would need to be addressed too. For example, should people who are dying be exempt from mandatory annuitization? If all or part of the balance is to be annuitized, what form should the annuity take? A simple life annuity would seem appropriate, but the Social Security benefit is effectively an indexed life annuity—and no significant market for indexed annuities has yet developed.

International Lessons

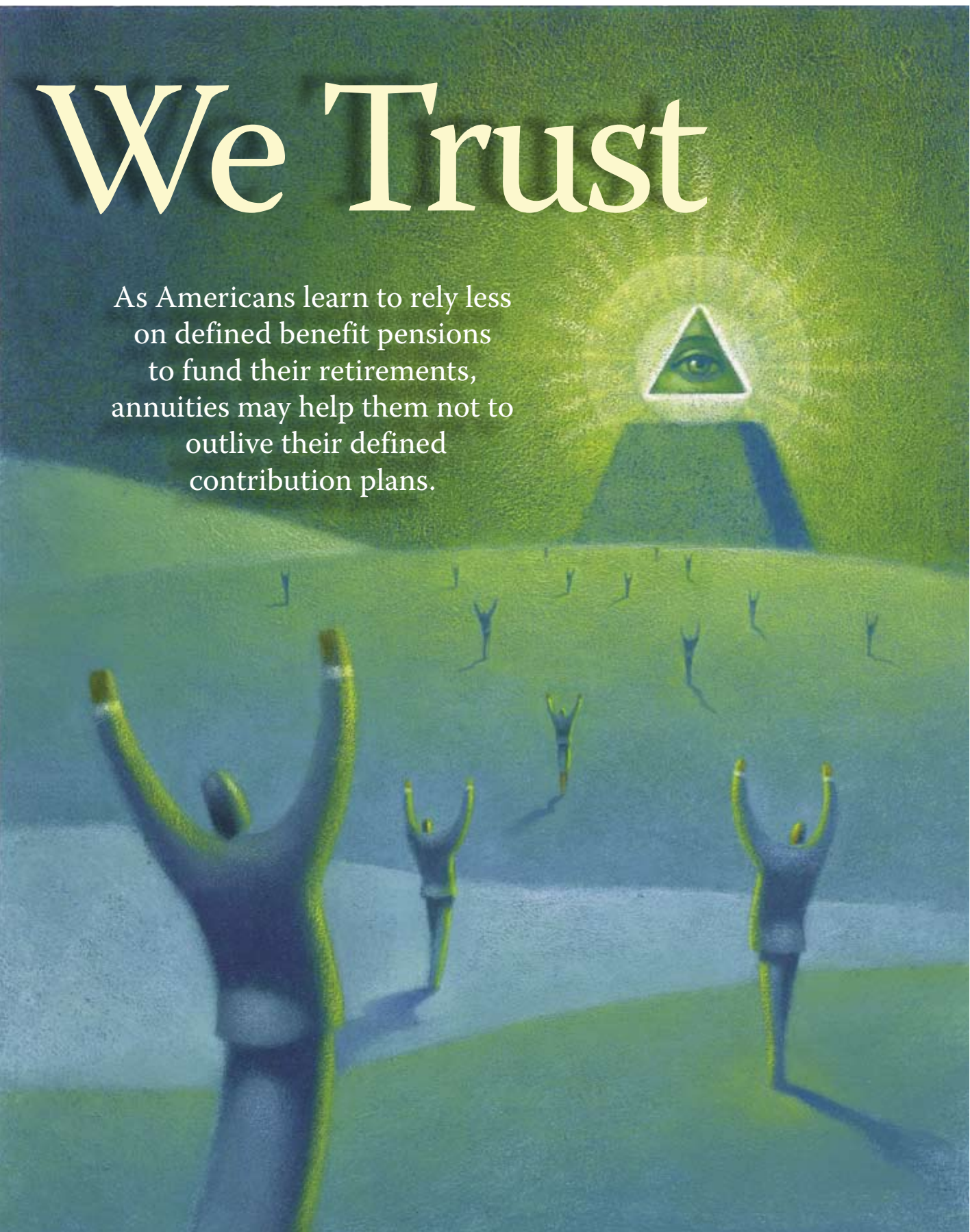
For the moment, the individual accounts reform is off the front burner in Washington. But the question of policy toward distributions will remain an important one for the country if such a reform is proposed again, and for pension policy in general.

It's certainly important elsewhere in the world. At least 24 other countries—including the United Kingdom, Sweden, nine countries in Latin America, and eight in Eastern and Central Europe—have an individual accounts component in their national pension system. In some countries it supplants—and in others it complements—the conventional pay-as-you-go system. Moreover, the provident funds found in a number of Asian countries are similar to individual accounts systems. The issue is clearly very much alive.

The international experience with individual accounts is well worth studying. Typically, reforming countries have decided that private financial institutions will provide the annuities or similar vehicles for the distribution of account balances on retirement. This means that effective regulation of the financial system is critical. Nearly all reforming countries have forbidden access to the funds in individual accounts before retirement and have determined that the account balance shouldn't be inheritable. They've dealt with the traditional benefits that public pension systems provide for family members in different ways.

We Trust

As Americans learn to rely less on defined benefit pensions to fund their retirements, annuities may help them not to outlive their defined contribution plans.



ROB COLVIN/IMAGE ZOO/PUNCHSTOCK



No one doubts the importance of ensuring that older Americans have importance of how the retirement

Chile, the pioneering country, which introduced its individual accounts system in 1981, has recently introduced reforms to the distribution phase to discourage too-early retirement. By continuing to work and contribute to the system, participants will be able to buy an annuity (or arrange a programmed withdrawal, which is somewhat like a certain annuity) that will provide a more adequate retirement benefit.

Chile has also reduced the upfront cost of annuitization. In Eastern Europe, the reforms are so recent that account holders have yet to begin annuitizing their balances. Nonetheless, these reforms raise basic issues about how these annuities are to be financed. In one country, for example, annuities are to be indexed, but no indexed financial assets exist.

As might be expected, Chile has a thriving market for annuities and a large insurance industry. A recent World Bank study found that Chilean annuities were competitively priced. As a general rule, however, annuity markets are small (unless the government is deliberately encouraging or requiring their purchase).

Annuity Markets and Pension Reform, the book from which this article is drawn, analyzes the range of issues that arise with distributions from individual accounts. It also considers how the market for annuities, which can be expected to grow given current demographic and financial trends, can be made to function better.

The book's premise, shared by many economists and actuaries, is that if the market for annuities is efficient and well regulated, annuities can provide valuable longevity insurance against the risk of retirees' outliving their financial resources.

Living Too Long

The market for annuities in the United States can be expected to grow over the next few decades as the population ages. In addition, the ongoing shift from defined benefit plans to defined contribution or hybrid plans will reduce the amount of savings that is automatically annuitized. People with moderately high incomes and a long career history who retire with defined contribution plans will have a large accumulated balance. A large balance will make the purchase of a life annuity, possibly with a guarantee feature, attractive. Finally, there is some reason to believe that the value of the Social Security retirement benefit relative to income, if not in absolute terms, may decline over time.

Growth in the individual annuity market, however, doesn't necessarily guarantee that older Americans will have enough longevity insurance. Consider someone who's just retired and who draws a monthly final-salary pension that, together with the Social Security benefit, replaces 70 percent of his income. We assume that his commutation option was restricted, so that most of the benefit takes the form of a life annuity with a survivorship feature if he's married.

Now suppose that instead of receiving a defined benefit, he retires with a large balance in an account under a defined contribution plan. Many options are open to him, but it's useful to contrast two in particular.

First, he could buy a life annuity with all or part of the balance and attempt to replicate the situation of having retired with a defined benefit plan. Second, he could simply choose to invest his savings prudently, and try to ensure that the rate at which he spent them wouldn't leave him penniless should he live for many more years.

This choice brings to the fore a simple but basic question: How much of a retiree's wealth should take the form of an annuity? Our retiree might devote his entire nest egg to the purchase of a single-payment immediate life annuity (assuming he has no potential heirs to worry about). But unless he's insured against any possible financial contingency, that approach would leave him unprepared for large medical bills or other contingencies.

Clearly, the optimal rate of annuitization of a retiree's wealth must be less than 100 percent. But it's easy to show that, provided annuities are reasonably priced, it must be greater than zero. This is true even when a retiree wants to leave a specific bequest.

Drunken Sailors

There is a legitimate debate about when a retiree should annuitize. Retirees who can handle financial market risk might wait until they're relatively old or annuitize in stages. However, even with early annuitization, the return on the annuity if the retiree remains alive is higher than the return on long-term bonds, and keeps right on paying.

In addition to longevity insurance, an annuity offers a valuable aid to self-control and self-discipline. If a retired person doesn't annuitize, she not only has to guess about how long she might live—and err on the conservative side—she also must be able to stick to a conservative drawdown schedule and forgo the undoubted pleasure of repeated splurges.

This isn't easy for all of us. There is a definite prospect that many retired Americans who will enter retirement with a nest egg that, with careful management and financial planning, should be enough to see them through retirement will end up falling short nonetheless.

Harvard psychologist Steven Pinker puts it graphically in his book *The Blank Slate* when he says that economists repeatedly find that people spend their money like drunken sailors. The irony is that while for some of us a large nest egg would burn a hole in our pockets, the extremely cautious would deprive themselves unnecessarily. Elderly misers may simply be terrified by the prospect of destitution, and few would blame them. Dante may have been on to something when he assigned both the hoarders and the squanderers, those who heeded no proportion in their spending, to a circle in hell. Both groups of souls might be saved—if not from hell, then from misery and privation—by an annuity.

Unless retirees with 401(k)s and IRAs choose to annuitize a large share of their balances, the shift away from defined benefit plans will almost certainly lead to a decline in the share of a retiree's annuitized wealth. For some people that could be a good thing, but odds are that for most it won't.

adequate resources at retirement, but many appear to slight the nest egg should be invested.

All Too Human

Can the decline in the share of annuitized wealth be avoided or at least partly offset? A similar question has been asked of the decline in the personal saving rate in the United States, which has now fallen to about zero percent of personal disposable income.

In recent years, a number of measures have been proposed to raise the saving rate, to increase the chances that Americans entering retirement will, in principle, have adequate resources to sustain themselves. These proposals start from the premise that human beings aren't the rational and consistent utility maximizers of traditional economic theory. When left to their own devices, most people can't save enough of their current income, and invest those savings prudently enough, to provide for their retirement.

Instead, recent studies on saving decisions support the view that people tend to be shortsighted and have little grasp of the relationship between the size of a nest egg and the flow of income it'll sustain. These studies also find that even if people can save enough, they lack an intuitive grasp of the need for diversifying their investments. All too often, people believe that holding the stock of their employer is a sensible diversification strategy.


In light of these foibles, economists have been arguing that people need a nudge to save enough and to invest their savings

wisely. This has led to proposals that new employees should be automatically enrolled in a company's 401(k) plan unless they specifically state otherwise. A similar approach can be used to encourage diversification in an employee's 401(k) or IRA portfolio. Similarly, a plan can be designed so that some specified fraction of any wage increase will be invested in the plan unless the employee directs otherwise.

This approach could be used to encourage annuitization of the balances in 401(k)s, IRAs, or even in individual Social Security accounts. For example, the plan might be designed so that a certain share of the balance would be automatically annuitized at retirement, unless the employee specifically opted out. Safeguards would have to be established to ensure that the premium per dollar of regular income wasn't excessive, and the plan would have to specify which choices would apply to survivorship options and to guarantees on the regular income.

The default setting for a married employee, for example, might need to be restricted to some kind of joint annuity. Similarly, because of the concern that many potential annuitants have over the consequences of early death, it might be sensible to make an annuity with some guarantee period (e.g., five years) the default.

A more radical approach would be to encourage employees,




Do you require assistance maintaining coverage during peak periods?

Do you desire veteran expertise for a special project?

Do you need support through a new initiative, conversion or implementation?

Actuarial Experience Delivered.

Jacobson Solutions delivers actuarial subject matter experts on demand for your interim, project-based and consulting needs. Our credentialed actuaries possess the functional and product line experience necessary for success on your specific assignments.



JACOBSON SOLUTIONS

WWW.JACOBSONONLINE.COM • TEL: (800) 466-1578

some years before retirement, to commit to purchasing an annuity once they reach the normal retirement age. The commitment would be irrevocable and subject to certain conditions, including a requirement that specified ceilings be observed on the annuitized balance in the account and on the premium per dollar.

Like the proposals that apply during the accumulation phase, the implications of these proposals for both employers and employees would need to be carefully thought through. Their legal and administrative implications aren't trivial. Employers have worried that an asset allocation default could leave them vulnerable to litigation should financial markets perform poorly.

These worries have their counterpart at the distribution stage. Employees might be disappointed by the terms of their annuity and blame their employers. Although the failure of annuity providers is improbable, judging from the American experience, the possibility of failure could raise similar concerns with both employers and employees.

Though the default setting approach could well increase the rate of annuitization, it may be more successful at the accumulation stage than at the distribution stage. The main issue at the accumulation stage seems to be lack of will or self-control. As with dieting, most people are convinced of the virtues of saving; the trouble arises when they try to put it into practice.

Better Education

At the distribution stage, many Americans might see the merit in a financial instrument that helps them control their spending, but the merits of longevity insurance aren't as well understood. Moreover, the lack of trust of many Americans in financial institutions makes them unwilling to part with a large upfront sum in return for an income stream that will stop with their death. Even financially literate people often associate annuities with the variable or deferred annuity, which is essentially an investment vehicle.

Despite Americans' lack of familiarity with this venerable financial instrument (a rule for the capitalization of an annuity's income stream is found in Roman law), the simple immediate life annuity is really a plain vanilla wrapper. It's defined by two numbers: the premium and the monthly payment from the insurance company. This suggests if employers' financial education programs placed greater emphasis—or even some emphasis—on how annuities work, their employees' mistrust and misunderstanding might be dissipated.

Such programs have been effective in raising participants' general understanding of personal financial issues; whether they actually change participants' behavior is less certain. Nonetheless, they undoubtedly help to raise the standard of financial decision-making. Americans who are self-employed or who work for small

DARWIN RHODES

• London • Hong Kong • Sydney • Mumbai •
• New York • Manchester • Leeds • Bristol •

Darwin Rhodes has been established since 1996 serving the needs of the actuarial profession, on a global basis. Darwin Rhodes carries out executive search assignments at senior level for clients. Our network of regional offices in the UK and worldwide enables us to identify the right individual to meet our clients' needs. Our team of local recruitment consultants are specialists within their field, including non-life, ALM, life, investments, banking or employee benefits, in both traditional and non-traditional areas.




If you are a client requiring our services or an individual seeking career advice please contact the relevant office:



For UK, Europe, Middle East
32 Threadneedle Street,
London EC2R 8AY
Tel: +44 (0)20 7763 6261
actuarial@darwinrhodes.com

For Americas
Suite 237, Level 3
75 Maiden Lane
New York NY10038
Tel: +1 212 402 7830
recruit@darwinrhodes.us

For Asia Pacific, India
Suite 802(A), Tower 1, Lippo Centre,
89 Queensway, Admiralty,
Hong Kong
Tel: +852 3101 0930
recruit@darwinrhodes.com.hk

Level 2, Raheja Centre Point
294 CST Rd, Near Mumbai University
Santacruz (E)
Mumbai 400 098 India
Tel: +91 22 5507 8764
recruit@darwinrhodes.co.in

For Australasia
Suite 10.03
46 Market Street
PO Box Q110, QVB
Sydney NSW 1230
Tel: +612 9231 7427
recruit@darwinrhodes.com.au

www.darwinrhodes.com
www.darwinrhodes.com.hk
www.darwinrhodes.com.au
www.darwinrhodes.us
www.darwinrhodes.co.in

Darwin Rhodes is an employment agency and a member of the REC

• London • Hong Kong • Sydney • New York • Mumbai • Manchester • Leeds • Bristol • Birmingham • Edinburgh • Shanghai • London • Hong Kong • Sydney • New York •

employers could benefit if they had the opportunity to attend continuing education financial courses. Given the importance of financial literacy to the community at large, there is a case for the government subsidization of such courses.

Annuities would also be more popular if they were better priced. With the expected growth of the market, the average life expectancy of the annuitant population is likely to move closer to that of the general population of the same age. In a competitive market, this will lead to a decline in the premium per dollar of income. If more and more 401(k) holders choose to annuitize, employers will be able to form groups and negotiate group rates that will be lower than individual rates. At the same time, the growing role of the Internet's market for financial transactions could reduce costs by obviating the need for individual sales representatives. With the decline in their role, average sales margins would decline as well.

The Social Security retirement benefit, in addition to providing longevity insurance, also provides inflation insurance. This combination makes it particularly valuable to older Americans. It's possible for private financial markets to duplicate this dual feature, as is evident from the experience of the United Kingdom, which has a fairly large market for indexed annuities.

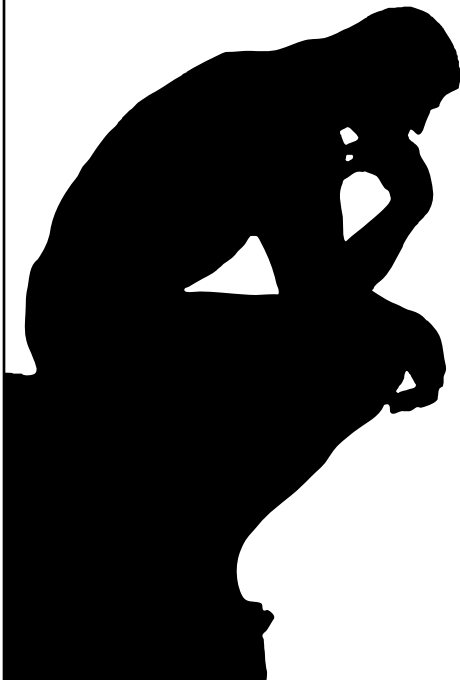
A sine qua non for the development of a market in indexed annuities is the development of a deep and broad market in indexed

debt, one that covers the whole maturity spectrum. In practice, this means that the government must issue indexed debt, as the United States does now in the form of Treasury Inflation-Protected Securities and I-bonds. The further growth in the pool of indexed securities would facilitate the development of the indexed annuities market.

To sum up, it's easy to overlook the importance of the distributive phase of both individual account systems, and the individual's life cycle of saving and distribution. No one doubts the importance of ensuring that older Americans have adequate resources at retirement, but many appear to slight the importance of how the retirement nest egg should be invested.

In fact, the two questions are inseparable. How much a retiree will need will depend in no small measure on the amount of longevity insurance he has. An efficient and well regulated market in life annuities and similar instruments will play a vital role in the well-being of older Americans in the 21st century. ●

GEORGE A. (SANDY) MACKENZIE is a guest faculty member of the Washington Center of the University of California. Previously, he was for many years a member of the staff of the International Monetary Fund. His book *Annuity Markets and Pension Reform* was published by Cambridge University Press in July 2006



Always **thinking** about risk?

If you're thinking about how to navigate the risk measurement and management journey, Ernst & Young's Insurance and Actuarial Advisory Services can help. Let us assess your progress against leading best practices. ey.com/us/actuarial

For more information, contact Doug French, Global Director of Actuarial Services at (212) 773-4120 or doug.french@ey.com.

Audit • Tax • Transaction Advisory Services

 **ERNST & YOUNG**
Quality In Everything We Do