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Annuities: The Broccoli of Retirement Planning

Nudging People to Choose Lifetime Income over Cash

Actuaries do it; economists do it; financial wizzes do it; why don't retirees do it? That is, while experts, among them several Nobel laureates, agree that most retirees should buy a lifetime annuity, very few people actually do. By annuity, I mean a simple single premium insurance contract that promises to pay $X a month for a person's life, or a couples' joint lives. Attempts by the Internal Revenue Service, the Department of Labor, and a number of proposals circulating in Congress to encourage folks to turn their 401(k)'s into guaranteed lifetime income will fail unless they consider the human reluctance to trade a pile of cash for relatively small monthly payments. Although economists puzzle over this "irrational" behavior, it's actually quite understandable. Let's look at why people hate annuities and how to change consumer attitudes.

What if I die early? People hate the idea that they might die early and the insurance company will "win." Of course, what really happens with annuities is that the folks who die early subsidize those living beyond their life expectancy. In effect, someone buying an annuity is using an insurance company to pool his or her mortality/longevity risk with the other annuitants. Since nobody knows when they will die, this is a fair deal. Also, once you're dead, you should not care whether someone else benefits from the pot of money you left on the table. Indeed, there's an argument annuities provide free insurance against living "too long" because this mortality premium is paid by the dead to

the living. Yet, loss aversion—the tendency of folks to feel more pain from a possible loss than satisfaction from an equal gain—further tilts the scale against purchasing lifetime income.

Annuities look expensive. To a human being (compared with an economist or actuary), it intuitively looks like a bad deal to hand over a large pot of money in exchange for the promise of small monthly payments in which it will take decades to break even. I know that always has been my gut reaction, with built-in insurance company profit and administration costs making annuities particularly pricey. So I did a back-of-the-envelope comparison of what a pension actuary estimates the cost of a lifetime annuity of $1,000 month without those add-ons to the actual cost of a single premium annuity in New York from a popular commission-free web site. The costs were surprisingly similar. The actuary pegged the single sum cost of a frictionless pension at $160,943 (male) and $171,395 (female), while the web sites' quotes were about $18,000 higher for the male or female. In other words, the insurer was charging a little over 10 percent to cover its costs and profits. No free lunch, but not bad for guaranteed income.

It's hard to make a decision. People naturally find it difficult to make a decision, especially a complicated one. Participant behavior with 401(k) savings is a case in point. Studies show that faced with the decision whether and how much to contribute and then choosing investments, many participants freeze and do nothing. And the more choices—the longer the investment menu—the less likely people are to take any action. When it comes to savings, employers have learnt to use this inertia to turn doing nothing into something by automatically enrolling workers and investing their contributions in a default investment. Choosing an annuity, however, is much harder than deciding how much to save and where to invest. Crucially, buying an annuity is permanent—once the ink dries and the sale is final, there are no do-overs. Plus, buying an annuity involves selecting a start date, deciding how much to invest, considering various payment options like single life vs. joint and survivor, and selecting an insurance company. Even those folks who may want an annuity might be paralyzed by the process.

Soiled waters. Some bad actors in the insurance industry have exacerbated the natural reluctance to buy an annuity. There's an old saying that "insurance is sold not bought." This attitude has led some agents and insurers to sell overpriced high-commission products, sometimes with unnecessary features, using pie in the sky projections and aggressive marketing. While in the minority, it's these abuses, not the success stories that get the attention adding to the anti-annuity bias.

Annuities are not risk-free. There's the risk, of choosing an insurance company that goes broke. While thankfully rare and generally

covered by state guaranty associations and similar protections, there is a tiny but real chance that the annuity promise will be broken. A related risk is of losing control and not having your nest egg available if your circumstances change or you just made a mistake. That is a scary thought when making a lifetime investment. Some annuitants assuage their fear of buyer's remorse and of early death with a return of premium or period certain feature—knowing that no matter what, they or their heirs will at least get their money back. Ironically, while this added protection makes an annuity appear less risky, the experts argue that it is a bad deal and people would be better off self-insuring the risk and buying a less expensive deferred annuity.

Not right for everyone. In solving the annuity puzzle, it's important not to overlook that this is not the solution for everyone's retirement strategy. First on the list are people with known serious health issues likely to fall on the short end of the mortality curve. The same goes for people with small nest eggs who would be better off keeping their cash in a rainy day fund to cover the inevitable car or home repair, health expense, or other financial emergency. The same holds for the super savers with more money than they need; these folks may be better off investing the money on their own and leaving what's left to the next generation or charity. Finally, some people who theoretically should buy an annuity may rationally decide to take their chances, for example because they'd rather frontload their spending while they're healthy and then curtail spending or simply suffer the consequences of running out of money later on when, perhaps, they're too out of it to care. For these reasons I don't think defaulting 401(k) participants into an annuity, even with an opt-out, is fair or workable. Is there some other way to get near retirees to do what is likely in their best interests but leave the final decision to them?

If we build it, will they come? Most 401(k) and other defined contribution plans do not offer a lifetime income payment option, and recent regulatory changes and legislative proposals are trying to promote annuity take-up from the supply side. The thinking is that employers don't offer annuities because they fear fiduciary liability if they pick an insurance company that eventually runs into financial trouble or offer a product that is simply too expensive. The perceived remedy is to encourage employers to add an annuity option by reducing the potential fiduciary liability and generally making annuity options more employer-friendly. Another fix is to require employers to regularly inform employees how much monthly retirement income their 401(k) account is likely to provide if it is annuitized. But even if employer plans offer a curated annuity option—with one or two vetted insurance companies, no commissions, a limited and reasonable choice of features, and some consumer education—will participants jump at the chance? I doubt it. Plans that currently offer a lifetime

income option see miniscule annuity take-up. Even defined benefit plans, which are designed to pay a lifetime pension but offer a lump sum option, see a significant minority of participants choose cash.

What to do. How can near retirees be nudged into overcoming their natural biases and using part of their nest egg to buy an annuity? Proposals to make it safer—fiduciary liability-wise—for employers to offer an annuity and translate participants' 401(k) balance into its annuity equivalent will move the needle a bit. But even if there was a perfect, off-the-shelf annuity program that employers could add to their 401(k)s with zero fiduciary liability, participants still will be reluctant to sign on.

Perhaps a completely new approach is needed. Participants will be drawn to taking cash as long as they think of their retirement savings as an available pot of money. What's needed is a new type of lifetime income plan that workers do not think of as simply a pile of dough. Of course, that is what a traditional pension was supposed to be, but for numerous reasons defined benefit plans are rapidly disappearing. One clever approach is the USA Retirement Plan discussed in this issue of *Benefits Law Journal*. The benefits gurus need to put their collective heads and algorithms together to create a lifetime income program that people want and will work.

The views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated.

David E. Morse
Editor-in-Chief
K&L Gates LLP
New York, NY

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