

# CRS Report for Congress

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## The Market for Retirement Annuities

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### Summary

A retirement annuity allows an individual to purchase a regular payment stream from an insurance company to last his lifetime. Despite the ability of the product to eliminate the risk that a retiree will outlive his assets, few retirement annuities have been sold in the individual market. In addition, the number of individuals who annuitize their defined contribution retirement plan balances remains small. New products are emerging that would offer alternate annuity designs and make annuity prices more attractive. Legislation has been proposed in the 109<sup>th</sup> Congress that would enhance the tax treatment of annuities and encourage the growth of stand-alone annuity and combined annuity and long-term care products. This report<sup>1</sup> will be updated as warranted.

**Types of Annuities.** An annuity is a contract made by an insurance company in exchange for a sum of money to make regular payments (usually monthly) for the life of the annuitant. Annuities can be classified as follows:

- *Immediate Versus Deferred* — Under an immediate annuity, an individual pays an insurance company a sum of money and the insurance company begins making regular monthly payments to the individual immediately. Under a deferred annuity, an individual pays the insurance company a sum of money and the insurance company begins making regular monthly payments beginning at least a year after purchase. For example, an individual at age 45 might buy a 20-year deferred annuity that would start making monthly payments when the individual reaches age 65.
- *Fixed Versus Variable* — A fixed annuity pays a flat monthly amount for the life of the annuitant whereas a variable annuity pays a monthly payment amount tied to the performance of an investment portfolio such as corporate stocks and bonds. Under a variable annuity, the annuitant bears the risk that the monthly annuity payment could go down.

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<sup>1</sup> The original author of this report is Neela Ranade, but it has been updated by Bob Lyke.

- *Level Payment Versus Graded Payment* — In a level payment annuity, the monthly payments remain level whereas in a graded annuity the monthly payments increase each year. The payments may increase at a specified rate such as 2% per year or may increase at the rate of inflation.
- *Single-Life Versus Joint-and-Survivor* — A single-life annuity makes regular monthly payments for the life of one person. A joint-and-survivor annuity makes regular monthly payments for the lives of two people, the primary annuitant and a secondary annuitant, typically the spouse of the primary annuitant.

There are other annuity variations. A *life annuity with a period-certain* makes monthly payments for the life of the annuitant or to a beneficiary for the remaining specified period in the event that the annuitant dies before the end of the period. Beginning in 1995, some insurers have started offering a hybrid type of annuity called the *index annuity* that combines some of the characteristics of fixed and variable annuities. In an *equity indexed annuity*, the annuity payment is based on the rate of return of a stock index. However, there is a minimum return provision, often of 3%, that eliminates the downside risk to the purchaser.

A *qualified annuity* is one for which the source of cash is funds that have been “qualified” for exemption from federal income taxes until the time of purchase. These could be payments from a defined benefit (DB) or defined contribution (DC) pension plan. However, few DC plans make annuities available. In 2004, just 23.5% of DC plans offered annuities as a distribution option, according to statistics from the Profit Sharing/401(k) Council of America. Hewitt’s 2005 401(k) survey shows that on average, just 6% of plan participants chose an annuity.<sup>2</sup> A *non-qualified annuity* is one that is purchased with funds that have not received any tax-sheltered status. Non-qualified annuities are typically purchased by individuals investing their after-tax savings to buy protection against outliving their assets.

To date, deferred annuities sold have been mostly of the variable type. Typically they have been sold on the basis of their advantages as tax sheltered investment products rather than as a way to protect against outliving one’s assets.<sup>3</sup> This report will focus on non-qualified immediate annuities.

**Increased Need for Annuitization.** On account of the shift from DB pensions to DC pensions and the tendency for retirees to take pension benefits in a lump sum, many retirees are facing the responsibility for making investment and spending decisions that will ensure that their assets will last for their lifetime. Income from guaranteed sources

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<sup>2</sup> Susan Kelly, “Inventing the Stretchable Retirement Dollar,” *Treasury and Risk Management*, Oct. 2005.

<sup>3</sup> Lately deferred variable annuities have come under attack from several state insurance departments for alleged abusive sales practices such as selling annuities with high surrender charges to individuals in their 70s and 80s who are probably too old to benefit from them, and exchanging one deferred variable annuity for another for no added advantage.

such as DB pension plans and social security retirement benefits is projected to drop from 74% of total retirement income in 1974 to 24% in 2030.<sup>4</sup>

Many experts believe that average life expectancy for the population will continue to increase. In addition, a specific individual could live well past the average. Although the average 65-year-old man and woman can expect to live to age 81 and 85 respectively, almost 20% of 65-year-old men and 33% of 65-year-old women will live to age 90 or beyond.<sup>5</sup> By purchasing an annuity, an individual can transfer the risk of managing assets to produce an adequate income stream through retirement over to the insurance company.

**Current Marketplace for Annuities.** As **Table 1** indicates, sales of immediate annuities have been dwarfed by sales of deferred annuities (mostly of the variable type). **Table 1** also shows that sales of fixed immediate annuities are much greater than sales of variable immediate annuities.

**Table 1. Annuity Sales in Individual Market in 2004**  
(amounts in billions)

Annuity Type	Assets at 12/31/2004	Sales in 2004
Immediate	\$46.7	\$5.6
<i>Fixed</i>	<i>not available</i>	\$5.3
<i>Variable</i>	<i>not available</i>	\$0.3
Deferred	\$1,656.0	\$209.2

**Source:** Information obtained from LIMRA International in e-mail message from Matthew Drinkwater to Neela Ranade dated Sept. 15, 2005. LIMRA International is an organization that provides research services to insurance companies.

**Table 2. Types of Immediate Annuities Sold in Individual Market by Percent of Premium**

Type of Annuity	Percent of Premium
Single Life (No Period Certain)	8%
Joint and Survivor (No Period Certain)	22%
Single Life with Period Certain	21%
Joint and Survivor with Period Certain	39%
Period Certain Only	10%

**Source:** LIMRA International Study of immediate annuities sold in 2000 and 2001; information provided by LIMRA International from Matthew Drinkwater to Neela Ranade dated Sept. 15, 2005.

**Table 2** shows the distribution of types of immediate annuities sold in the individual market. Single life annuities with no further payment guarantees for a minimum period or to a surviving spouse have the lowest sales indicating that purchasers are leery about paying a large sum that may lead to very little payoff in the case of premature death.

<sup>4</sup> Jeff Mohrenweiser, "The Evolving U.S. Retirement System," *The Actuary*, Mar. 2003.

<sup>5</sup> J.R. Brown, "Life Annuities and Uncertain Lifetimes," *NBER*, Spring 2004.

**Annuity Pricing.** The purchase price for an immediate annuity depends on the mortality assumptions used in pricing. Although most insurers use sex-distinct mortality tables to price non-qualified immediate annuities, some states require the use of unisex mortality rates. When sex-distinct rates are used, the annuity price for a woman will typically be greater than the price for a man at the same age because women live longer than men. The annuity price will also depend on the interest rate assumed to be earned by underlying investments. The interest rate used is typically the rate on long-term corporate bonds of good quality. The annuity price will be lower when interest rates are high.

In the U.S. market, the annuity price generally does not depend on the health of the applicant even though an individual in poor health could be expected to live fewer years and therefore cost the insurer less. The vast majority of immediate annuity policies are issued without underwriting. The pricing of these annuities assumes that the applicants are very healthy and will live longer than the average population. Recently, some progress has been made in the issuance of so-called “impaired life annuities,” which are annuities sold to individuals in less than average health. Impaired life annuities were sold initially only in connection with “structured settlements.” Structured settlements are agreements to pay compensation in a series of payments often as a result of an award to an accident victim.

Annuity prices for individuals in impaired health may come down as a result of the issuance of actuarial guideline IX-C by the National Association of Insurance Commissioners (NAIC).<sup>6</sup> Actuarial Guideline IX-C, effective for annuity contracts issued after January 1, 2001, allows the insurer to hold a significantly lower reserve, thereby reducing the purchase price. For IX-C to apply, the annuity must be sold to an individual with a medical condition that reduces the life expectancy of the individual by at least 25%.

**Emerging Products.** There has been considerable discussion of new types of annuities that will meet market needs. Some insurers have released products. Many more are likely to enter the market if there is favorable legislation.

**Inflation-Indexed Annuities.** An inflation-indexed annuity (a graded annuity under which payments increase each year at the rate of inflation) would likely be of interest to retirees if available at an attractive price. For inflation-indexed annuities to be priced attractively and for a large market to develop, the U. S. Treasury may need to issue inflation-indexed bonds in sufficient volume and of long enough duration. This would allow an insurer that sells inflation-indexed annuities to invest underlying assets in inflation-indexed Treasury bonds.

In an inflation-indexed annuity, an insurance company pays larger amounts at later durations than a level payment annuity. For example, if the inflation rate turns out to be 3% per year, an inflation indexed annuity purchased by a retiree at age 65 for \$1000 per month would be paying the retiree \$2,427 per month at age 95. This makes the financial risk of entire population cohorts living longer than expected, greater for an insurer that

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<sup>6</sup> Actuarial Guideline IX-C is titled “Use of Substandard Annuity Mortality Tables in Valuing Impaired Lives under Individual Single Premium Immediate Annuities.”

sells inflation indexed rather than level payment annuities. Some believe that for a large inflation-indexed annuity market and indeed for any large annuity market to develop, it would be necessary for the government to issue “mortality bonds” to underwrite the risk of a cohort of the population living much longer than expected. The future coupons on a mortality bond would depend on the percentage of population of retirement age on the issue date who are still alive on the future coupon payment dates.

Although true inflation-indexed annuities are rare in the current marketplace, there are some products that provide some inflation protection. Vanguard (through an arrangement with American International Group Inc.) offers an annuity that provides inflation indexing up to a maximum of 10% inflation.<sup>7</sup> An equity indexed annuity should provide a higher return in the long run than a fixed annuity because over the long run stocks can be expected to out-perform bonds. However, stocks do not always move in tandem with inflation.<sup>8</sup>

**Longevity Insurance.** The deferred variable annuities sold in the past were designed to be investment vehicles rather than protection against outliving one’s assets. Recently, some insurance companies such as New York Life and MetLife have started offering deferred annuities designed to be true longevity insurance. New York Life’s core product consists of a deferred annuity of the fixed payment type with payments beginning at age 75.<sup>9</sup>

Whether an individual chooses to buy an immediate annuity or longevity insurance depends on the degree of investment management that the individual wishes to take on. An individual retiring at age 62 may decide that he or she can have his or her assets managed to provide an income stream until age 75 and buy longevity insurance that will provide an income stream to begin at age 75. A more risk averse individual might wish to buy an immediate annuity that would begin income payments immediately at age 62.

**Other Emerging Annuity Products.** Some annuity products allow an individual to buy a series of deferred annuities at different points in time, beginning at the retirement age. This reduces the possibility of the investor investing a large sum of money in what turns out to be a period of historically low interest rates.<sup>10</sup> Another product that is in the development stage is the combined annuity and long-term care product. The price of a combined annuity and long-term care product could be 3%-5% lower than buying each product separately.<sup>11</sup>

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<sup>7</sup> “The Inflation Protection You Can’t Get: In Search of an Indexed Annuity,” *The Wall Street Journal*, May 25, 2005.

<sup>8</sup> Mitchell, Brown, and Poterba, *The Role of Real Annuities and Indexed Bonds in an Individual Accounts Retirement Program*, NBER Working Paper No. 7005, Mar. 2005.

<sup>9</sup> “Longevity Insurance: New Products Attempt to Solve an Age-Old Problem,” *The Wall Street Journal*, Aug. 10, 2005.

<sup>10</sup> “Insurers Expand Annuity Products for 401(k) Plans,” *The Wall Street Journal*, Mar. 16, 2005.

<sup>11</sup> See “Insurance Helps Balance Risk in Retirement” by David Wessel, *The Wall Street Journal*, Nov. 17, 2005.

**Legislation.** Legislation has been introduced in the 109<sup>th</sup> Congress that would encourage individuals to buy annuities for retirement income. Some of the legislative proposals would also facilitate creation of products that combine annuity products with long-term care, which should lead to increased sales of annuity products as well as added coverage for long-term care.

***The Retirement Security for Life Act of 2005 (H.R. 819, S. 381).*** This legislation was introduced on February 15, 2005, by Representative Nancy Johnson and Senator Smith and other members. It would provide incentives to encourage the purchase of life annuities by excluding 50% of the annuity income (up to a maximum of \$20,000 annually) that would otherwise be subject to federal income taxes under current law. The \$20,000 limit would be adjusted annually for inflation beginning in 2007. Income from state and local government and nonprofit deferred compensation plans and from qualified retirement plans (such as individual retirement accounts or 401(k) plans) would not be eligible for this exclusion.

***Lifetime Pension Annuity for You Act of 2005 (H.R. 2951).*** This legislation was introduced on June 16, 2005, by Representative Earl Pomeroy. It is similar to H.R. 819 and S. 381 as described above but would also exclude 25% of the otherwise taxable annuity income from qualified defined contribution retirement plans and from state and local government (but not nonprofit) deferred compensation plans. Annual exclusions would be limited to \$5,000 (or \$10,000 in the case of joint returns).

***Flexible Retirement Security for Life Act of 2005 (H.R. 3912).*** This legislation was introduced on September 27, 2005, by Representative Nancy Johnson and other members. It is similar to H.R. 819 and S. 381 as described above, but would phase in the exclusion over 10 years. The exclusion would be limited to \$1,000 in 2006, rising to \$20,000 in 2015. The \$20,000 limit would be adjusted annually for inflation beginning in 2016.

H.R. 3912 would also provide enhanced tax treatment for combined annuity and long-term care products. Under current law, long-term care benefits paid as part of a rider to an annuity contract are considered taxable income. The bill would make such long-term care benefit payments exempt from federal tax. The exemption would not apply to qualified retirement plans. H.R. 3912 would also allow individuals to exchange an annuity for a long-term care policy on a tax-free basis. Under current law, an individual exchanging an annuity for a long-term care policy would incur tax on the cash value of the annuity.

***Pension Protection Act of 2005 (H.R. 2830).*** The primary focus of H.R. 2830 is to reform funding rules for defined benefit pension plans. However, the legislation also includes provisions to facilitate development of combination annuity and long-term care products. For a nonqualified annuity contract with a long-term care rider, H.R. 2830 would make long-term care benefit payments nontaxable. It would also allow an individual to exchange a nonqualified annuity for a long-term care policy on a tax-free basis. The Senate counterpart of H.R. 2830 is S. 1783 and does not contain these provisions. The two bills are currently in conference.