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Thank you for inviting comments on the use of annuities for retirement income.

Our expertise is not in product development or sales, but in the analysis of WHEN it is appropriate for individuals to purchase annuities. We have developed very sophisticated software for helping people make this and other decisions when they are retired, or close to retirement, and we believe we are the best that exist in this particular business. To the extent that your project is attempting to give people better options about annuitization, therefore, our experience is relevant. So we would emphasize the following points:

Retirees have an alternative already: preserve the principal and live off the income. True, this alternative does not work so well in very low interest rate environments, but neither do traditional annuities. It also does not work perfectly even in normal interest rate environments, because longevity cannot be predicted on an individual basis the way insurers can predict it on a composite basis – so individuals have no good basis for amortizing their principal, which means that they derive less spendable income from their savings than a commercial annuity would pay. *But this is not necessarily a problem.* Given the high costs of long-term care that many people incur at the end of life, it is helpful to keep the principal intact, in case that need arises. If it does not arise, many people like the idea of leaving an inheritance to children or grandchildren, or as they age, they may benefit from access to their principal for any number of other reasons. Also, if they become truly aged, they can start spending some of their principal without worrying much about it. Recent annuity products sold to individuals can include riders that allow partial access to one's principal, but these riders are expensive to purchase in that they significantly reduce the "premium" that an annuity pays to an individual over and above the "living off the interest" amount. And in cases where an annuity ends up mostly just replicating what an individual can do on his/her own, it is a poor alternative, because it includes a lot of overhead (sales costs, service costs, profits) that an individual does not incur. This does *not* mean that annuities are not right for *anybody*, because they are, frequently. But not for *everybody*.

It is hard to determine who will be better off with an annuity and who will not. There is no established way to do this in the industry. Some people treat annuities as an asset allocation alternative to traditional asset groups, providing a conservative and guaranteed income stream that permits individuals to invest more aggressively with other portions of their savings. Others look at annuities as a pure mortality hedge, or as a tax shelter. It can be all of these things. But the bottom line is: since the individual is giving up control of his/her funds, and perhaps the ability to pass it along to heirs, is the individual likely to be better or worse off in a "normal" scenario, and/or in a scenario where lifespan significantly exceeds life expectancy, and/or in scenarios where alternative risks occur (such as if long-term care is needed)? This is hard to evaluate for two reasons: (1) you need to understand the complete financial picture of the household, not just their investments and not just their other income sources, if you want to be able to answer this question; and (2) the individual may have other resources that are not conspicuous, such as the ability to lean on children or other family members or friends, or some willingness to accept governmental or community safety nets if their luck runs bad.

The best age to purchase an annuity is impossible to determine in advance, but it usually is in one's 70's. If you buy a traditional annuity too soon, your income is low because the insurer has to amortize your principal over such a long period of time. If you buy an annuity too late, you don't get enough payments to justify the cost. "Too soon" and "too late" depend heavily on when

you die, and so they cannot be determined in advance with any precision. But in general, depending on other factors (such as gender, health, and how many lives are covered), the optimal age to purchase a traditional annuity tends to be in one's 70s, or even later. ***Since most people retire well before then, creating incentives for people to buy annuities at retirement is not doing them a favor.*** People destined to die relatively young will have been better off not buying an annuity at all. People destined to live longer will have been better off waiting until they were older to make the purchase. (NOTE: Variable annuities work differently, and the optimal age may in fact be younger, depending on how the annuities are structured. But variable annuities have high fees, and they are relatively pointless unless someone wants to put a large portion of their funds into the securities markets. For people who are actually at risk of running out of money, taking on additional risk on investments is usually a poor choice, inside or outside an annuity. I can argue this at more length, if you like, but for now I'll leave it at that.)

Tax incentives are not an effective way to get most people to buy annuities who actually need them for retirement security. The reason I say this is that most retirees at risk of running out of money are not wealthy and do not have much taxable income, so that they are typically in the 15%, 10%, or even 0% marginal tax brackets. The motivational incentives of tax breaks at those marginal tax rates is minimal, or non-existent.

The right way to motivate people to purchase annuities is to encourage them to purchase them in smaller amounts over time, and to reward them for the first purchase. This strategy benefits everyone. It benefits the individual, because purchasing smaller amounts every two or three years is a more rational strategy than making one big purchase – since, as noted above, the optimal time to buy an annuity cannot be known in advance. Picking what will turn out to be the right date is really a gamble, so the sensible strategy is not to place all one's chips on one guess, but to spread them out over three, four, or maybe five different ages. This strategy also works better for everyone who wants to encourage the use of annuities, because it is more effective than the usual tactic of trying to get someone to make a big commitment all at once. People with limited financial resources are naturally reluctant to give up control of a big chunk of their assets in exchange for a promise of future income. It is psychologically more astute to ask them to make a much more modest commitment at first, so that they still directly own most of their assets, and so that if they die soon or just don't like the annuity idea in the end, they have not over-committed, and can feel smart about having held back. But in reality, most people will enjoy getting that check every month, and after a couple of years, when they realize they can get even more money back from an additional annuity purchase (because they are older now), they will be much easier to persuade. Under this approach, what we need, therefore, is an incentive only for the first purchase.

What kind of incentives should be offered? If it were up to me (though many industry officials might disagree), I would first of all limit whatever incentive is offered to the purchase of immediate fixed annuities only, it would be available only for people aged about 70 and up, and it would be a once-in-a-lifetime incentive. The dollar amount would also be limited, either in absolute dollars or (theoretically better, but probably less practical) as a percentage of assets. What should the incentive be? As noted above, tax incentives are relatively unhelpful. What people really care about are: (1) having thrown away their money if they die soon after making the purchase; (2) not having access to their money if an unexpected need arises, and (3) losing their money if the insurance company goes bad. Encouraging the purchase of annuities in increments instead of in big lump sums ameliorates all three of these concerns. In addition: a federal guarantee against risk #3 would probably cost very little, as long as the federal agency backing the guarantee was the LAST resort rather than the first one – because the industry and the states already do an excellent job of covering this risk. A federally-backed program to guarantee the availability of personal loans to annuity purchasers could reduce problem #2, and again, could probably be structured in a way that would not cost much. Problem #1 would be eased if some kind of modest death benefit was provided by the government if someone died within, maybe, three or five years of their first annuity purchase. A few thousand dollars might be enough – and since people generally don't buy annuities unless they understand themselves to be in good health,

these small payments would rarely have to be made. Whatever the details, incentives of this kind, that speak to the actual reasons people are reluctant to purchase annuities, will surely be more effective than an equivalent federal expenditure on tax incentives.

I would be happy to offer more details on any of these points, if you are interested. I certainly DO support the idea of the government encouraging people to use annuities, assuming that they are encouraging them to do it intelligently – i.e., purchasing appropriate products at the appropriate time of life, and preferably only when such a purchase actually makes sense for that particular person or family.

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