

Annuities and Other Lifetime Income Products: Their Current and Future Role in Retirement Security

- ✓ A new survey finds that older workers are definitely interested in lifetime income options.
- ✓ Options to allow for partial annuitization, gradual annuitization, and a trial approach could further increase the demand for annuities.
- ✓ Many workers with substantial defined contribution balances might benefit from the longevity insurance that annuities provide.

Life annuities and similar products supplied by insurance companies have never been very popular with Americans, but recent trends in employer-provided pensions, demographic developments and innovations in the types of lifetime income products available may change that. The declining role of the traditional pension and increasing life expectancy are leaving more and more Americans with limited

insurance against longevity and enhancing the potential role of private annuity providers (see box 1 for the definition of different plan types and related terms).

To shed some light on the current and potential role that annuities and other lifetime income products play in Americans' retirement plans, AARP conducted an extensive survey of older

Box 1. Glossary

Cash balance (CB) plan—a defined benefit plan in which the benefit is determined by the rate of contribution set by the plan and a rate of interest applied to the member's balance that is normally fixed. A CB plan is similar to a defined contribution plan in that it has a balance and the benefit is normally in the form of a lump sum, not an annuity.

Defined benefit (DB) pension—an employer-provided pension plan with a benefit that is determined by the terms of the plan. The traditional form is a final salary plan, in which the pension is determined by the number of years of plan service and end-career salary.

Defined contribution (DC) pension—a pension plan that determines the contributions that members pay, but not the benefit they receive. A typical employer-provided DC plan specifies a contribution rate as a proportion of salary. With some DC plans members have no say in how the funds are invested, but in most plans investments are member-directed.

Life annuity—a financial instrument that pays the annuitant a monthly stream of income, normally fixed, that lasts from the first payment until the death of the annuitant. Life annuities commonly come with a guarantee period to ensure that payments will be made for at least a few years even if the annuitant dies during this period.

Longevity insurance—insurance where the payout depends on the number of years lived, as is the case with a life annuity, which pays as long as the annuitant lives.

workers and recent retirees. The survey obtained information on the type of retirement plan or plans workers and retirees had, the value of their plan balances, the extent to which their plan and Individual Retirement Account (IRA) balances were or will be annuitized, and their views about whether innovations to the annuity market could make annuities more popular. This fact sheet provides initial findings from the survey.

The Survey

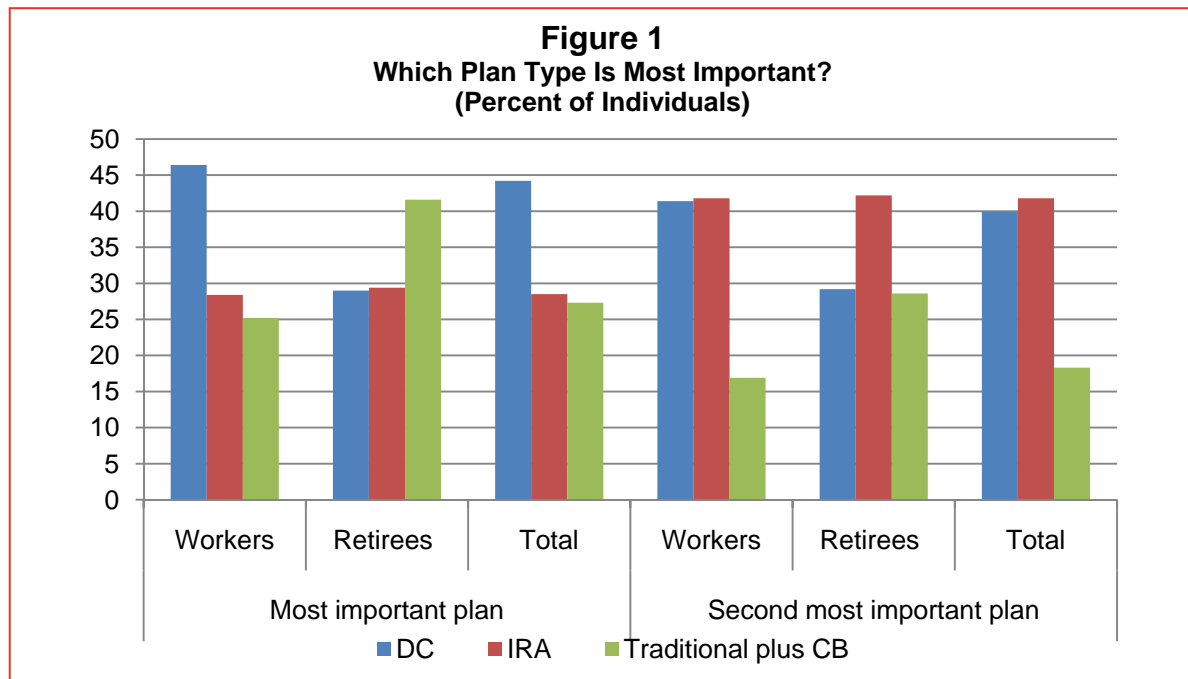
The survey, conducted in April 2010, interviewed 1,750 working and 670 retired Americans. Workers were between the ages of 50 and 75, and retirees between the ages of 59 and 75. To qualify for the survey, participants had either to be members in at least one employer-provided pension plan or to own an IRA. Retirees had to have begun withdrawing or receiving benefits from their most important retirement plan within the past three years. Participants with more than one plan or IRA were asked to identify which plan they considered to be most important and second most important. The questions put to workers and retirees were

similar, except that workers' responses for all plans reflected their planned choices while retirees' responses regarding their most important plan reflected their actual choices. Their responses regarding their second most important plan reflected their actual choices if they had started taking benefits from that plan.

Preliminary Findings

Type of Plan

About 46 percent of older workers and 29 percent of recent retirees represented by the survey named a 401(k) or other DC plan as their most important plan. The cash balance plan, a defined benefit plan that looks like a DC plan, has apparently not yet made substantial inroads in coverage. Retirees, who are older on average than workers, were more likely than workers to name a traditional pension as their most important plan and less likely to name a DC plan (see figure 1). About 28 percent of workers and retirees had another plan that they considered important. As was the case with the most important plan, retirees were more likely than workers to name a traditional plan, and less likely to name a DC plan as their



next most important plan. The IRA was a very common choice for second most important plan.

Distribution Options

DC plans generally allow members to withdraw 100 percent of their plan balance as a lump sum. Other options are not always available. Of participants whose most important plan was a DC plan, 26 percent of workers and 46 percent of retirees stated that their plan offered a life annuity option. Traditional or CB plans are required to offer a life annuity or a joint and survivor annuity to their members. Of participants whose most important plan was a traditional or CB plan, about 30 percent of both groups said that their plan offered members a lump-sum option. Half of workers with a DC plan did not know whether an annuity was offered and more than a quarter of workers with a traditional DB or CB plan did not know whether a lump sum was offered. Retirees were more knowledgeable, as might be expected.

Retirement Income Choices

The survey found that of participants in traditional plans that offered a lump sum option, 63 percent of workers intended to forego a lump sum and opt for an annuity, while no less than 87 percent of retirees had already made that choice. These estimates are higher than those of other research, but such research is limited.¹ About 31 percent of workers and 25 percent of retirees who were members of DC plans offering options other than a lump sum were planning to select or had selected the annuity option.

Interest in Alternative Choices

Pension plan participants may have only a limited choice between different distributive options, if they have a choice at all. For example, they may be able to annuitize 100 percent of their pension, or take it all as a lump sum, but

nothing in between. The survey's findings suggest that such limited choice may reduce demand for annuities. Of participants whose most important plan was a traditional plan that either did not offer lump sum option or offered that option without a combination option, 31 percent of workers and 15 percent of retirees declared themselves very or somewhat interested in a combination of annuity and lump sum. Of these, 82 percent of workers and 88 percent of retirees would annuitize no more than half of the total benefit. Of the 57 percent of workers and 35 percent of retirees whose most important plan was a DC plan without an annuity or combination option and who declared themselves very likely or somewhat likely to take a partial option if it were available, about 77 percent of workers and 65 percent of retirees would annuitize no more than half of their account balance.

Understanding and Appeal of Annuities

When asked why they had picked an annuity, both retirees and workers, regardless of the characteristics of their plans emphasized such reasons as the peace of mind brought by knowing income would never run out, and the ease of budgeting facilitated by predictable income.

These findings suggest that annuities have some appeal among working Americans, even when the standard or default option is the lump sum withdrawal, and that if more plans offered an annuity option, the incidence of annuitization would increase. Actually increasing the use of annuities or other lifetime income options will likely require greater familiarity with annuities, however. The survey finds that 51 percent of workers and 67 percent of retirees described themselves as very familiar or somewhat familiar with these instruments. However, as noted, 50 percent of workers in DC plans did not know if their plan offered an annuity.

What Inhibits Annuity Demand

Survey respondents were asked why they had not chosen an annuity option when that option was available, or why they would not have chosen an annuity had the option been available to them. The survey invited them to choose among a lengthy list of responses reflecting the reasons that economists have advanced to explain annuities' comparative lack of popularity and asked them to evaluate how convincing they found the reasons to be.

No single or small number of reasons dominated the answers of either workers or retirees. The reasons cited as most convincing were the perceived ability to earn greater returns elsewhere, the risk or fear of dying prematurely, the need to have funds available for an emergency (for example, a serious or protracted illness), poor value for money, the loss of control of the capital used to purchase the annuity, and the lack of adequate information to make a choice. The lack of trust in the honesty and integrity of annuity suppliers and the need for money up front were less important, although fear of the insolvency of annuity providers was a factor. A standard explanation among economists for the limited interest in annuities has been the desire to leave a bequest, but this was a less important motive than those already noted.

Two Novel Approaches to Annuitization

Given many people's lack of understanding about annuities, an arrangement under which a person could acquire a life annuity for a trial period, perhaps two years, could increase familiarity with and understanding of annuities. The survey results supported this view. Of workers whose DB plan has no lump sum option or who had no plans of electing the annuity option, 51 percent declared themselves very or somewhat likely to elect a trial arrangement, which would give them the option of taking a lump sum at the end

of the trial period. Retirees in a similar position were less likely to elect a trial arrangement, possibly because they are already more familiar than workers with life annuities. Of participants with a DC plan that lacked an annuity option, or had one that the participant did not plan to take, about 64 percent of workers and 50 percent of retirees were very or somewhat likely to consider a trial arrangement. Some 53 percent of workers and 35 percent of retirees whose most important plan was a IRA and who were not aware of an annuitization option or who had no plans to annuitize would be very or somewhat likely to consider a trial arrangement.

Another approach to boosting annuitization is to encourage the gradual annuitization of contributions to DC plans made over the course of a plan member's working life. This approach means that a member is not faced with the decision of converting a large balance into an annuity at the end of his or her career with only one or a few payments. Of survey participants whose most important plan is a DC plan without an annuity option or without one they would choose, 56 percent of workers and 51 percent of retirees would be very or somewhat likely to dedicate some of the funds in their DC account to that purpose. Of participants whose most important plan was an IRA who were unaware of an annuity option or were not planning to annuitize, 46 of workers and 30 percent of retirees expressed this range of interest.

Conclusions

The survey's findings suggest that there may be significant untapped demand for lifetime income products and that more lifetime income options in retirement could increase the welfare of older Americans. This conclusion rests in part on the stated intentions of survey respondents and their responses to hypothetical situations. Further research

will compare these intentions with the actual choices reported by the recently retired. Nonetheless, it does appear that the market for gradual annuitization could grow, and that the trial approach could increase annuity demand. In addition, increasing the flexibility of distribution options would mean that DC plan members and IRA holders would not be obliged to devote all of their balances to buying an annuity and running the attendant risk of over-annuitization. This fact sheet has presented only initial

survey findings. The survey has yielded a rich load of data, and will allow us to investigate the questions touched on here in a more systematic and deeper way. Subsequent research will examine variation in views about annuities and distribution choices across demographic characteristics, receptivity to different types of information about managing income in retirement, and the difference between what workers say they will do and what recent retirees have done.

¹ A study by researchers at Vanguard found that 27 percent of defined benefit plan participants from two large plans who were eligible for a lump-sum distribution chose to take annuity as the payout option. Gary R. Mottla and Stephan P. Utkus, *Lump Sum or Annuity? An Analysis of Choice in DB Pension Payouts*, Vanguard Center for Retirement Research, Vol. 30, November 2007.

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