RETIREMENT INCOME INSTITUTE

Alliance for Lifetime Income

Who Should Read This Insight:
Retirement investors, financial professionals, annuity manufacturers, annuity distributors

Institute Research Agenda Topic:
Understanding differences in consumer behavior and decision-making

Definitions of **bold key terms** are at the end of this article.

PAUL M. SECUNDA,
is a Partner at [Walcheske & Luzi, LLC,] in Milwaukee, Wisconsin, where he practices employee benefits and labor law. He is a member of the American College of Employee Benefits Counsel, former Chairman of the ERISA Advisory Council, and has written numerous books, chapters, and articles on retirement security issues.

Authors, Titles and Publication Dates of the Articles Addressed in the Insight

Banerjee, Sudipto. 2017. "How Does the Level of Household Savings Affect Preference for Immediate Annuities?" Employee Benefit Research Institute Insight 430, February 8.

Sudipto Banerjee is Professor and Chair of the Department of Biostatistics in the School of Public Health at the University of California, Los Angeles (UCLA). He is best known for his work on Bayesian hierarchical modeling and inference for spatial data analysis.

Insight: HOUSEHOLD SAVINGS AND LEVEL OF RETIREMENT INVESTORS' INTEREST IN IMMEDIATE ANNUITIES

IDEAS IN THIS INSIGHT YOU CAN PUT INTO ACTION

When considering differences in consumer behavior and decision-making with regard to annuities, the amount of savings that **retirement investors** have determines to some extent their preference for annuities. Both the wealthiest and the least wealthy investors recognize the value of having some **annuity** investments in their retirement portfolios. Both these groups seem to prefer **annuitization** of one-quarter of their retirement savings over annuitization of one-half or more of their savings. The middle group appears to prefer no annuitization at all presently, which helps explain the current low demand in the United States for annuity products. **Annuity manufacturers, annuity distributors,** and **financial professionals** can help retirement investors by better framing the use of annuities as part of an effective retirement approach.

PRINCIPAL INSIGHTS

Immediate annuities should be a part of any retirement income portfolio, yet currently most annuities are purchased by only the lowest- and highest-income consumers. Although Sudipto Banerjee's study suggests immediate annuities should be marketed specifically to these types of retirement investors, it also suggests that those in the middle should be better educated about the benefits of annuities and encourage to buy lifetime annuities to have an enough money in retirement. With the ongoing decline of traditional pensions, known as **defined-benefit plans,** that primarily feature annuity options, **defined-contribution plans** like 401(k)s and 403(b)s have taken over the private-sector retirement space in the United States. Historically, payouts from defined-contribution plans have been in the form of lump sum money payments, and individuals have been free to invest or not invest their retirement monies as they see fit. The principal problem with this approach is that no one is able to predict with any certainty their age at death. Since we do not know in advance how long we will live, we risk outliving our assets. Although other sources of retirement income exist, such as Social Security and private savings, most Americans cannot live adequately in retirement on these funds alone.

Consequently, more focus recently has been placed on the need for partial annuitization or, to put it more simply, on having an annuity investment as part of one's overall retirement income portfolio. Annuities are simply monthly income payments that work like replacements for paychecks during retirement. They have the advantage of lasting through the recipient's life, and in some cases through the **beneficiary's** life. The most prominent example of an annuity is Social Security, which continues to pay the beneficiary and a survivor for the rest of their lives. The challenge for retirement investors, financial professionals, annuity manufacturers and distributors, and policymakers is how to promote partial annuitization as a method to keep individuals who are in defined-contribution plans from spending all of their retirement savings before they die. This is especially important because individuals have increasingly long lives in retirement.

In his article, Sudipto Banerjee notes that, historically, annuities have not been preferred by many retirement investors in the United States. He offers several possible explanations: (1) Social Security already offers annuity income, (2) retirement investors want to leave money to their heirs, (3) investors worry they will die too soon to take advantage of an annuity income stream, (4) they want more available money for health and other emergencies in later life, (5) annuities have been associated with higher costs, and, finally, (6) retirement investors do not fully trust the financial strength of insurance companies that issue annuities.

The author recognizes the advantages of annuities in retirement income portfolios and the diversity of annuity products in the marketplace, and yet consumers still seem cautious about making annuities part of their retirement strategy. The author believes the first issue in understanding how to encourage more individuals to adopt retirement portfolios with annuities is to better understand consumer preferences for annuities.

Banerjee focuses on the most popular and easily understood annuity product: the **immediate annuity.** Immediate annuities begin paying out a regular stream of income as soon as they are purchased. His goal is to determine whether efforts to encourage consumers in low- and middle-income households to **annuitize** will succeed if those consumers prefer to keep their money in a vehicle that they can easily access.

The author's analysis is based on four different components of wealth and the individual's amount of monthly income. Banerjee tests participants' reactions to four different ways of investing in an annuity, known as annuitizing their savings: full annuitization (100% of savings annuitized), half annuitization (50% of savings annuitized), quarter annuitization (25% of savings annuitized), and zero annuitization (0% of savings annuitized). After annuitization's effects on monthly income and remaining savings were explained to participants, they were asked which type of annuitization they would prefer.

The author's findings produce at least five principal insights about consumer preferences for annuities. First, those who were in the top 25% of household savers and those in the bottom 25% of household savers (with less than $50,000 in savings) are more likely to be interested in some degree of partial annuitization than those in the middle 50% of household savers. Second, of those who are interested in annuitization, most are interested in some form of partial annuitization. The most popular choice was 25% of one's retirement income portfolio being invested in annuities.

Third, Banerjee suggests that the reason that those who have the least wealth could have more comparative interest in annuities is because a high percentage of these individuals' retirement income comes from Social Security (meaning that as much as 75% of their retirement income is already in annuity form). Also, people with the least amount of savings are very likely to run out of money in retirement. Selecting annuities further hedges against the possibility of outliving one's assets. On the other hand, the author also recognizes that, to the extent low-income individuals prefer not to buy additional annuities to supplement Social Security, it may be because they believe they are already sufficiently annuitized. In other words, a lack of demand for private annuities among this group might not necessarily indicate dislike of annuities in general.

Fourth, wealthier households recognize the value of partial annuitization as a means of avoiding complex and difficult decisions about spending down their retirement savings. Annuities automatically provide consistent and uniform spending down of one part of the household's retirement portfolio. Banerjee concludes that because of their wealth and their access to top medical care, household savers that are the most well off are likely to live longer; it makes sense for them to receive set payments for their presumed longer retirement. Furthermore, because they are relatively well off, they have additional monies set aside for other costs in retirement such as medical emergencies, long-term care, and travel expenses. In addition, depending on how much money they have saved and their family situation, they are also able to have annuities in their portfolios while, at the same time, leaving money in a trust or through a will for inheritance purposes after their deaths.

Finally, uncertainty is the primary reason that household savers in the middle appear the least comfortable with investing in annuities. People in the middle generally face more uncertainty about the adequacy of their retirement savings and so are more likely to hold on to their savings in an easily accessible form (in checking, savings, or money market accounts, or in stocks, for example) for precautionary purposes. Many middle-income individuals would also like to have some money left over to leave a financial legacy for their heirs.

To learn more, visit the Retirement Income Institute at
www.allianceforlifetimeincome.org/retirement-income-institute

KEY TERMS ARE SOURCED FROM THE ALLIANCE FOR LIFETIME INCOME'S ANNUITIES LANGUAGE GLOSSARY AND INVESTOPEDIA

Annuitization: *The process of converting an investment into a series of periodic income payments by buying an annuity or beginning an income flow from an annuity.*
Annuitize: *When you turn your current account balance into a series of periodic income payments, either for a specific period of time or for your whole life.*
Annuity: *A financial product that can offer protected lifetime income and even potentially grow your money.*
Annuity distributor: *An annuity distributor is anyone who is involved in the sale of an annuity to a consumer.*
Annuity manufacturer: *The insurance companies that produce annuities.*
Beneficiary: *The person you designate to receive any remaining account balance or income payments should you pass away.*
Defined-benefit plan: *A defined-benefit plan is an employer-sponsored retirement plan where employee benefits are computed using a formula that considers several factors, such as length of employment and salary history.*
Defined-contribution plan: *A defined-contribution plan is a retirement plan that's typically tax-deferred, like a 401(k) or a 403(b), in which employees contribute a fixed amount or a percentage of their paychecks to an account that is intended to fund their retirements.*
Financial professional: *A qualified person who can help you understand your options and make financial decisions to work toward your financial goals.*
Immediate annuity: *An annuity that begins paying out guaranteed income within one year after the date of purchase, either for life or for a selected time period.*
Retirement investor: *Someone who invests his or her own retirement savings, regardless of type.*

For industry use only.