RETIREMENT INCOME INSTITUTE
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LIFE ONLY ANNUITY RISK ISN'T REALLY A RISK

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Some financial advisors and academics underscore the "risk" that an annuitant can lose the entire premium of an income annuity by dying prematurely. While it's true that certain types of annuities—a single premium immediate annuity (SPIA), for example—have "life only risk," they represent a mere 3% of total annuity sales. Yet even among SPIAs, roughly 90% of quotes and sales include some type residual benefit guarantee.

Therefore, while "life only risk" exists with a very small percentage of annuities, including SPIAs, it can easily be eliminated, which means that life only risk really isn't a risk.

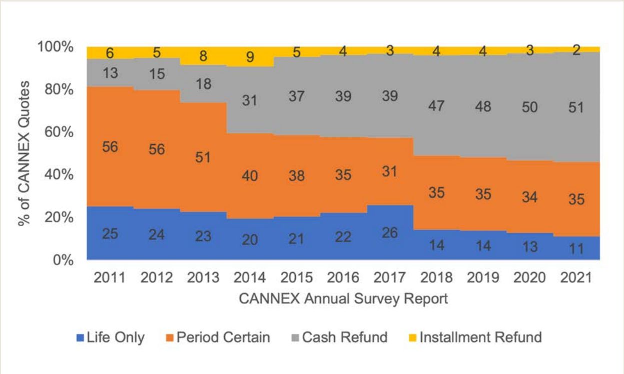
MONEY BACK GUARANTEES

Early research on the potential benefits of annuities focused on SPIAs and assumed a life only benefit. With SPIAs, the annuitant permanently cedes the initial premium to the insurance company for a guarantee of income for life where the income benefits commence immediately. With life only benefits, there is no type of residual benefit that would be available to the annuitant's heirs upon death, regardless of the amount of income received.

Life only benefits can appear to be risky, since the annuitant could receive significantly less than the initial premium if they die shortly after purchase. For example, if an individual were to purchase a life only SPIA with $100,000 and then pass away after receiving the first monthly income benefit (e.g., $500), the effective rate of return on the initial premium would be a staggering -99.5%. While this potential loss shouldn't necessarily matter to a retiree with no bequest motive, it is nevertheless a psychological barrier to annuitization. This same barrier is why many retirees don't delay claiming benefits from Social Security—an example of a lifetime income benefit that has life only risk that cannot be mitigated. While it does provide for spousal and survivor benefits, there's no type of benefit to get your payroll taxes refunded or the lost benefits from delaying.

The concerns regarding life only income benefits are why insurance companies offer a variety of annuities with residual guarantee structures, such as cash refund, period certain, and installment refund. With a cash refund, the annuitant will receive the outstanding portion of the premium as a lump sum upon death, thereby providing a "money back" guarantee. Certain period guarantees provide benefits for years regardless of how long the annuitant survives, with a 10 year period being the most popular term. Installment refund is similar to cash refund, but the benefits continue at the same schedule until the premium has been refunded.

The relative popularity of the guarantee periods has varied over time, an effect noted in the exhibit below, which includes a distribution



Source: CANNEX Annual Reports

of the respective features using data from CANNEX Annual Survey Reports from 2011 to 2021, which is primarily SPIAs.

While period certain was the most common guarantee period in 2011 (at 56% of quotes), by 2021 cash refund had become the most popular (included on 51% of quotes). Of particular note is the relative lack of popularity of life only quotes among, as well as their steady decline in recent years. Life only quotes went from 25% of total quotes in 2011 to 11% of quotes in 2021.

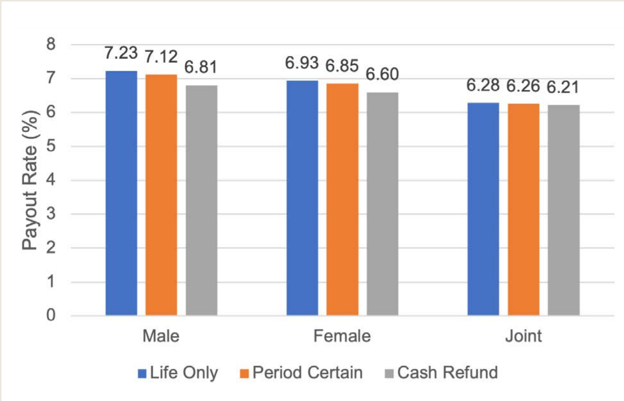
Since the previous exhibit includes information on quotes (not sales), I spoke with a few people at insurance companies that are the top sellers of SPIAs to get a better handle on sales volume. While the values provided varied, overall sales estimates were relatively in line with the quote distribution, which suggests that only approximately 10% of SPIAs sales are life only (as well).

Other more common annuities that provide lifetime income, such as a variable or fixed annuity with a lifetime income benefit, do not have the same type of life only risk as a SPIA, since the annuitant's heirs would generally be expected to receive the contract value upon death (or even more if an additional rider has been included). This is especially important because these types of products, including variable annuities, are significantly more common than products that have life only risk. SPIA and DIA sales only represented 3% of total annuity sales in 2021, according to an analysis by LIMRA, which means only a small fraction of a relatively small fraction of total annuity sales had a life only benefit structure.

IMPACT ON PAYOUTS

While including a cash refund or period certain guarantee with a SPIA would be expected to reduce the income benefit, the impact isn't especially significant. This is demonstrated in the next exhibit, which includes payout rates for SPIA quotes obtained from CANNEX on January 13, 2023. The quotes are for a 65-year old male, female, and joint couple (male/female with 100% continuation) where the respective payout rate (annual income divided by the premium) is the average of the top five available quotes.

Payout Rates for a SPIA With Various Refund Provisions



Source: CANNEX, Quotes as of January 13, 2013

The impact of including period certain and cash refund provisions varies. Payouts are reduced the most for the male annuitant, which is due to males having the shortest life expectancy, followed by female and the joint couple. The reduction in the joint couple payout is especially small, declining from 6.28% (life only) to 6.21% (cash refund), which is approximately a 1.1% reduction.

CONCLUSIONS

As the data plainly illustrate, both the prevalence and risk of SPIAs and other annuities with "life only" benefits are relatively scarce. Therefore, financial advisors and academics need to be careful not to overstate the "risk" that an annuitant can lose the entire premium of an income annuity by dying prematurely there doesn't have to be a risk at all!