

TIAA-CREF institute

## **POLICY BRIEF**

### ANNUITIZATION: WHAT INDIVIDUALS SAY, WHAT INDIVIDUALS DO

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**POLICY BRIEF****EXECUTIVE SUMMARY**

- The issue of converting accumulations into income is garnering attention with the growth of defined contribution retirement plans. A life annuity is one of the most efficient means to maximize wealth while guaranteeing an income stream. Most defined contribution plans, however, do not offer an annuitization option.
- Seventy-one percent of pre-retirees are concerned that they may not be able to maintain a reasonable standard of living for the rest of their life. Such concerns are reflected in that 69 percent of retirement plan participants consider receiving a guaranteed monthly amount during retirement, no matter how long they live, to be very important.
- At the same time, however, workers think it very important in choosing a payout option that they maintain control of their savings (61 percent) and that they have protection from loss of annuity value if they should die early (49 percent).
- These attitudes and preferences likely conflict at some level for individuals and do not necessarily lead to annuitization of retirement savings. Current annuitization rates are relatively low.
- The challenge with self-management of assets in retirement is that the vast majority of individuals appear ill suited for the job; only 31 percent are very confident in their ability to manage their investments during retirement.
- Retirees would benefit from more readily available annuitization options and from increased communications and education regarding the benefits of annuitization as an asset management tool.

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### INTRODUCTION

The growth of defined contribution (DC) retirement plans, such as 401(k) plans in the private sector and 403(b) and 457 plans in the non-profit and public sectors, has changed the landscape of retirement income security for American workers. The fraction of families with a 401(k)-type account has increased from 32 percent in 1992 to 67 percent in 2001.<sup>1</sup> In 1992, 38 percent of families with a pension plan participant had only a DC plan; by 2001, that portion had grown to 58 percent. The fraction with both a defined benefit and a defined contribution remained unchanged over this time period at 23 percent.

The increased importance of DC arrangements means increased decision-making responsibilities for working Americans. Much attention has focused on decisions during the accumulation phase: participation, contribution levels, asset allocation and asset preservation at job change. Some have argued that defined contribution plans are doomed to failure because the majority of workers are ill equipped to make these decisions wisely.<sup>2</sup>

Research, however, published in the *American Economic Review*, finds that pension benefits are higher with 401(k) plans than defined benefit plans, with the typical worker receiving an extra 38 percent of retirement income from 401(k) plans.<sup>3</sup> The authors conclude, “that the trend toward 401(k) plans has strengthened the retirement security of current workers.”

As assets in defined contribution plans continue to grow,<sup>4</sup> as assets in IRAs increase due to job-change rollovers,<sup>5</sup> and as baby boomers approach retirement with accumulations in such accounts,<sup>6</sup> the issue of converting these accumulations into income is garnering attention. After all, the objective of any retirement plan is retirement income security for workers and the accumulation of assets alone does not ensure achievement of this objective. Retirement assets must be managed and decumulated in retirement in such a fashion as to provide meaningful income levels for as long as the retiree lives.

Research by the Employee Benefit Research Institute concludes that early evidence demonstrates that some recent retirees are not on the right track as regards asset management. It found that 15 percent of a 64-74 year-old cohort studied had lost 50 percent or more of their total wealth from 1992 to 2002 and about 30 percent had lost 50 percent or more of their financial wealth. On the other hand, the research also indicated that a significant fraction of retirees might have a standard of living below that which could realistically be maintained throughout their retirement, i.e. they could actually be under-spending from their accumulated resources.<sup>7</sup>

Annuitization is the only asset management strategy that converts retirement savings into a guaranteed stream of income that cannot be outlived – guarantees are based upon the insurers’ claims paying ability. However, most defined contribution plans do not offer an annuitization option and current levels of annuitization among retirees are low.

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This article synthesizes previous research to examine the attitudes of workers and retirees regarding the receipt of income from their retirement plans, the reasons behind low annuitization rates, annuitization options available to workers, the value of annuitization, and satisfaction levels among those who have annuitized assets.

### ATTITUDES

According to recent surveys by the Society of Actuaries, pre-retirees are worried about not having enough money throughout their retirement.<sup>8</sup> Thirty-four percent are very concerned that they may not be able to maintain a reasonable standard of living for the rest of their life; while an additional 37 percent are somewhat concerned. In other responses, 36 percent of pre-retirees report they are very concerned that they might deplete all their savings and be left only with Social Security, and an additional 29 percent are somewhat concerned about this possibility.

These concerns are reflected in the features workers with retirement plans consider very important in choosing a payout option. Sixty-nine percent of workers with a plan consider receiving a guaranteed monthly amount during retirement, no matter how long they live, to be a very important feature. Similarly, 69 percent of workers with a plan consider ensuring they do not outlive their money during retirement to be a very important feature.

Such concerns are further reflected in the preferences of many retirement plan participants to receive their retirement benefits as regular payments for life. Sixty-six percent of workers with a retirement plan would prefer to receive their retirement income as a series of regular payments for the rest of their life. Examining this preference by plan type, 71 percent of workers with a defined benefit plan would prefer regular payments for life and 57 percent of workers with a defined contribution plan would prefer regular payments for life.

At the same time, however, workers think it very important in choosing a payout option that they maintain control of their savings (61 percent of workers) and that they have protection from loss of annuity value if they should die early (49 percent of workers).

Therefore, these attitudes and preferences likely conflict at some level for individuals and do not necessarily lead to annuitization of retirement savings. If retirees want to maintain control of their savings, they may try to manage their assets and investments themselves and draw regular payments on their own.

The challenge with such a self-management approach is that it appears to be a task that the vast majority of individuals are ill suited to undertake. Most workers with retirement plans are not very confident in their ability to manage their retirement assets during retirement. Only 31 percent are very confident in

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their ability to manage their investments during retirement. Only 21 percent are very confident in their ability to allocate their investments and savings among different types of investments. Finally, only 19 percent are very confident in their ability to make the right decision so as to convert a lump sum of retirement savings into a stream of income that will last the rest of their life.

The end result is uncertainty as to whether workers will actually annuitize their savings, which is the only sure way to achieve their stated retirement income security objectives. Only 43 percent of pre-retirees think it is a good idea to buy annuities to protect against the financial risk of living longer than average.

### BEHAVIOR

Current annuitization rates are relatively low. According to one survey, less than one-half of households currently near retirement (48 percent)<sup>9</sup> expect to annuitize at least some portion of their defined contribution account balances when they retire.<sup>10</sup> As noted, the majority of defined contribution plan sponsors do not offer annuitization options at retirement.

Upon reaching retirement, TIAA-CREF participants can choose from a variety of options to begin receiving an income stream from their accumulated pension assets. Among those starting an income stream from their retirement assets in 2001, 45 percent chose a life annuity (either single- or joint-life), 27 percent chose the minimum distribution required by federal law, and 28 percent chose another non-annuity option. The percentage initially choosing an annuity option has declined steadily following the introduction of non-annuity options for TIAA-CREF participants in 1989.<sup>11</sup>

Why are annuitization rates low? Numerous reasons have been hypothesized and all likely play a greater or lesser role.<sup>12</sup>

- Lack of availability through work-based retirement plans.
- Lack of consumer understanding.
- Liquidity concerns among retirees.
- Preexisting annuitized payments, such as Social Security and defined benefit pensions.
- Self-insurance among family members.
- Bequest motives among retirees.
- Adverse selection and resulting higher premiums.

While increased availability of annuity payout options in defined contribution plans would certainly help, it appears that workers also need more information and education so they better understand the basic concepts of annuitization and risk-pooling, as well the various options available to them if they wish to annuitize. For example, joint and survivor options are available to help protect a spouse should an annuitant die first, as well as options for additional payments to survivors in the event the annuitant dies “prematurely.” Annuitants can also choose a “fixed” annuity where payment amounts are guaranteed (based upon the

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insurers claims paying ability) or a “variable” annuity that has the potential for greater returns, but where payments fluctuate with the equity investments chosen.

### **BENEFITS**

Research demonstrates that a life annuity is one of the most efficient means for a risk adverse individual to maximize wealth while guaranteeing an income stream. Recognizing that annuitization is not an all-or-nothing decision, but rather a question of how much to annuitize and when, the authors of a recent study analyzed the benefit of annuitizing a portion of a retiree’s portfolio. The authors found significant improvements in the likelihood a retiree will maintain a target level of income with annuitization of one-half, or even one-quarter, of assets. For example, a retiree with a conservative asset allocation (20% stocks, 50% bonds, 30% cash) has a 33 percent chance of maintaining annual withdrawals of 4.5 percent of initial account balance (adjusted each year for inflation) for 30 years. By annuitizing 25 percent of the portfolio, the probability of maintaining this level of annual income increases to 53 percent. Annuitization of 50 percent of account balance increases the probability to 81%. A retired investor with a more balanced allocation (40% stocks, 40% bonds, 20% cash) would see his or her likelihood of success increase from 76 percent with no annuitization to 85 percent with annuitization of 25 percent of assets and to 95 percent with annuitization of 50 percent of assets.<sup>13</sup>

Individuals that have annuitized assets are quite satisfied with their decision. According to a report by the American Council of Life Insurers, 22 percent of immediate annuity owners consider their annuity one of the best financial decisions they ever made and 60 percent think it was a good financial decision. Forty-six percent of annuitants said the most important reason they annuitized was because it provides a source of regular monthly retirement income. Seventy-six percent of annuitants think the predictable monthly income is a very important benefit, and 86 percent of those with a life annuity think that payments that will last as long as they live is very important.<sup>14</sup>

### **CONCLUSION**

In an increasingly defined contribution dominated retirement environment, asset accumulation is necessary, but not sufficient, for a financially secure retirement. Ultimate retirement income security is also dependent upon managing accumulated assets in retirement so that they result in an adequate stream of income for the lifetime of a retiree (and that of his or her spouse.) This is the next challenge for individuals, plan sponsors, service providers and practitioners.

Future research undoubtedly will explore further whether Americans are better off in retirement in the new era of increased individual responsibility over retirement funds. In any case, retirees would benefit from more readily available annuitization options as part of their retirement savings plans. They would also benefit greatly from increased communications and education regarding annuitization and its benefits as an asset management tool.

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- <sup>1</sup> Copeland, Craig. "Individual Account Retirement Plans: An Analysis of the 2001 Survey of Consumer Finances." EBRI Issue Brief Number 259, July 2003.
- <sup>2</sup> Ferguson, Karen and Kate Blackwell. Pensions in Crisis. New York: Arcade Publishing, 1995.
- <sup>3</sup> Samwick, Andrew A., and Jonathan Skinner. "How Will 401(k) Pension Plans Affect Retirement Income?" The American Economic Review: Vol. 94, No. 1, March 2004.
- <sup>4</sup> Assets in private trustee defined contribution plans (\$2.0 trillion) now exceed those in private trustee defined benefit plans (\$1.5 trillion). See "Assets in Qualified Retirement Plans, 1985-2002: Revised," Facts from EBRI, September 2004.
- <sup>5</sup> IRA assets totaled \$3 trillion in 2003. See Copeland Craig, "IRA and Keogh Assets and Contributions," EBRI Notes, Vol. 25, No. 8, August 2004.
- <sup>6</sup> See Holden, Sarah, and Jack VanDerhei. "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2003." EBRI Issue Brief No. 272, August 2004.
- <sup>7</sup> Copeland, Craig. "Changes in Wealth for Americans Reaching or Just Past Normal Retirement Age." EBRI Issue Brief no. 277 (January 2005).
- <sup>8</sup> The Society of Actuaries recently sponsored two surveys to better understand the attitudes of workers and retirees regarding the receipt of retirement income. The Retirement Plan Preferences Survey surveyed workers currently with a retirement plan and retirees who retired with retirement benefits, and the Risks and Process of Retirement Survey surveyed all individuals age 45-80, both pre-retirees and retirees. For detailed results, see <http://www.soa.org/ccm/content/areas-of-practice/special-interest-sections/areas-of-expertise/post-retirement/>.
- <sup>9</sup> Among heads of households ages 51-61 who are employed and covered by at least one defined contribution plan.
- <sup>10</sup> Brown, Jeffrey R. "How Should We Insure Longevity Risk in Pensions and Social Security?," Issue Brief No. 4 (Center for Retirement Research at Boston College), August 2000.
- <sup>11</sup> Ameriks, John. "Recent Trends in the Selection of Retirement Income Streams Among TIAA-CREF Participants," TIAA-CREF Institute Research Dialogue, Issue No. 74, December 2002.
- <sup>12</sup> For a complete discussion, see Brown, Jeffrey R. and Mark J. Warshawsky, "Longevity-Insured Retirement Distributions From Pension Plans: Market and Regulatory Issues," NBER Working Paper No. 8064, January 2001.
- <sup>13</sup> Ameriks, John, Robert Veres and Mark J. Warshawsky. "Making Retirement Income Last a Lifetime," Journal of Financial Planning, December 2001.
- <sup>14</sup> American Council of Life Insurers, Profile of Immediate Annuity Owners,