
Retirement Income and Annuities

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Before we start, what do you think...

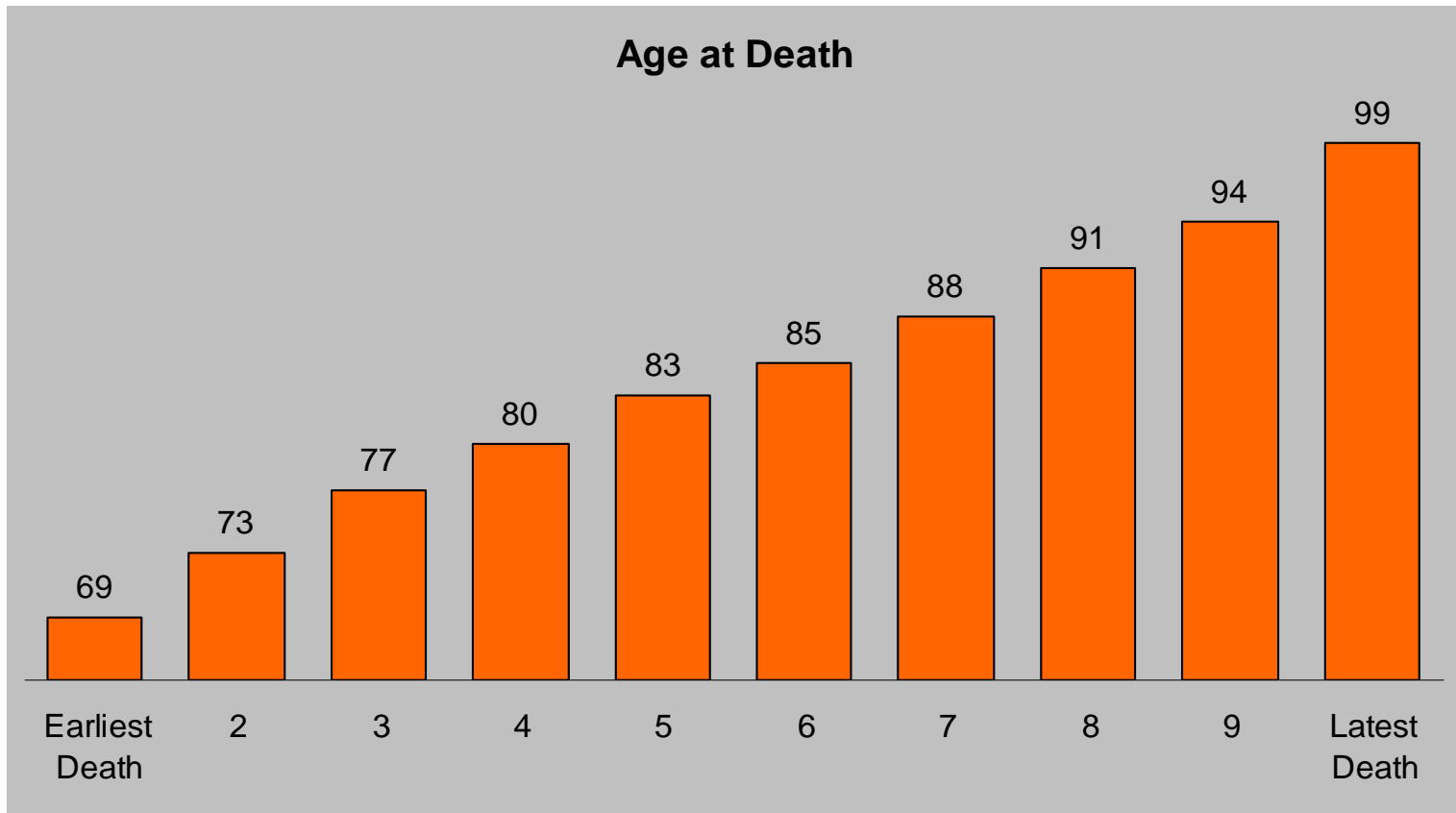
Do you view the decumulation phase as part of your fiduciary responsibility?

1. Yes
2. No

Outline

- The problem: Longevity is risky
- How should people handle longevity risk?
- How do people actually behave?
- What are the barriers to annuitization?
- How could we help consumers make better financial decisions in the decumulation phase?

Variability in longevity for 10 people who reach age 65



Longevity is a risky proposition

- Among 10 people who reach age 65, one will live as little as 4 years and another will live as long as 34 years.
- Put differently, one individual needs to fund 4 years of retirement income and another has to fund 34 years of income.
- Longevity risk is significant.

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What do you think...

Should retirees annuitize their defined contribution accounts?

1. Yes, all of it
2. Yes, most of it
3. Yes, about half of it
4. Yes, but less than half of it
5. No, not at all

What does the theory tell us?

- Yaari (1965) predicts full annuitization of retirement wealth under the assumption of no bequest motives.
- Davidoff et al (2005) suggest significant annuitization if bequest motives exist.
- Sinclair and Smetters (2004) propose minimal annuitization in the presence of an uninsurable healthcare shock costing \$50k - 200k.

So, what does the theory really tell us?

- If you ask enough academics, you will get confused!
- Given the mixed theoretical predictions, let's agree that most people should annuitize some of their retirement wealth, but not all of it.

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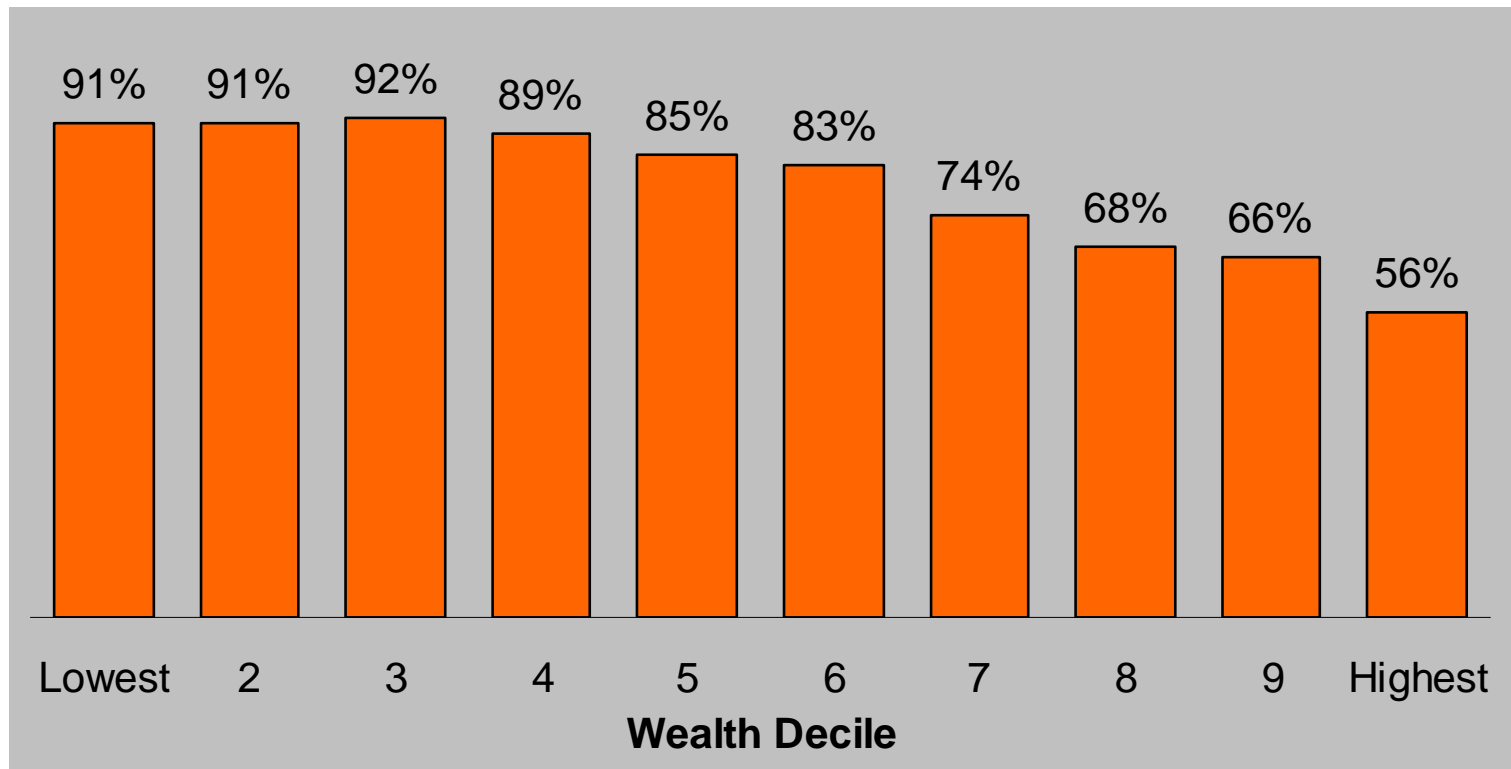
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What do you think...

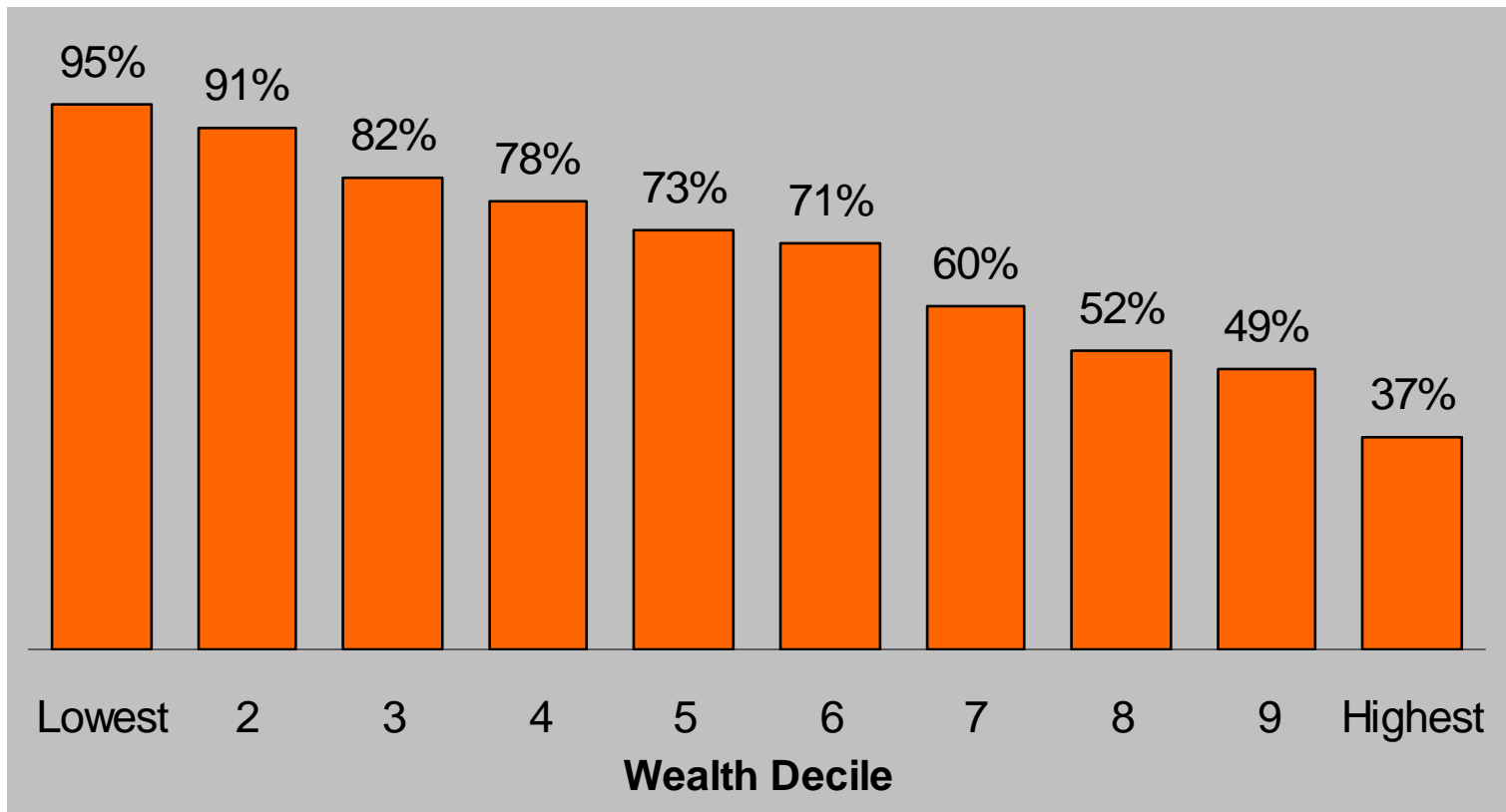
What percentage of retirement and financial wealth is annuitized at age 65?

1. All of it
2. Most of it
3. About half of it
4. Less than half
5. None

Percentage of retirement and financial wealth “annuitized” at age 65: People with DB plans



Percentage of retirement and financial wealth “annuitized” at 65: People without DB plans



Do people have sufficient protection against longevity risk?

- Most people have a significant fraction of their wealth annuitized.
- Most annuitization is either mandatory or “passive” in the form of Social Security and DB pension benefits.
- The switch to DC plans and the gloomy prospects for our Social Security system predict lower levels of annuitization.

And, retirees seem to set suboptimal spending rules

- Income for older widows falls by 47% following the death of their husbands, pushing 17% into poverty.
- Do people need more help handling their finances at retirement?

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What do you think...

What is the most important reason retirees do not annuitize on their own?

1. They already face compulsory annuitization
2. Loss of control and liquidity
3. Annuities are a bad deal
4. Annuities are not accessible in most DC plans
5. Lack of knowledge about annuities
6. Regret aversion

Barriers to annuitization

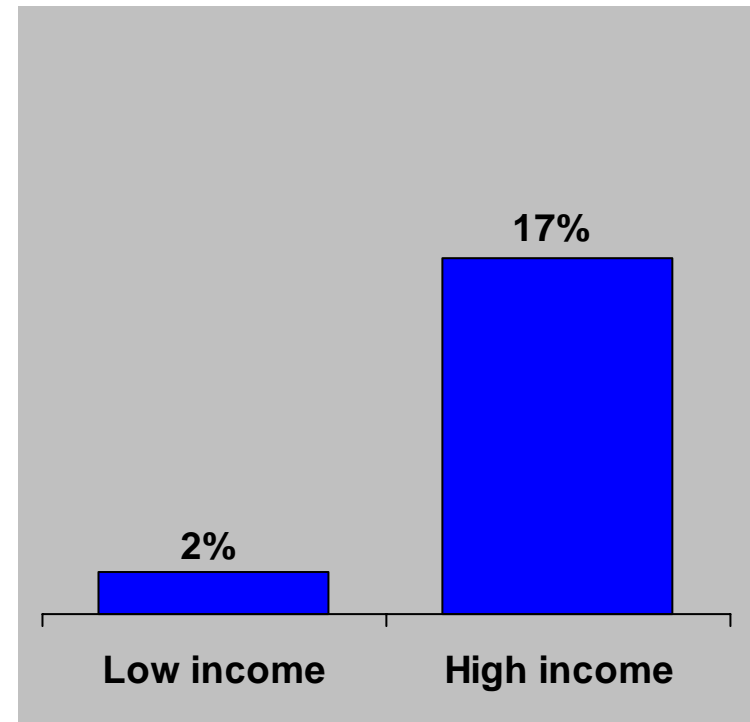
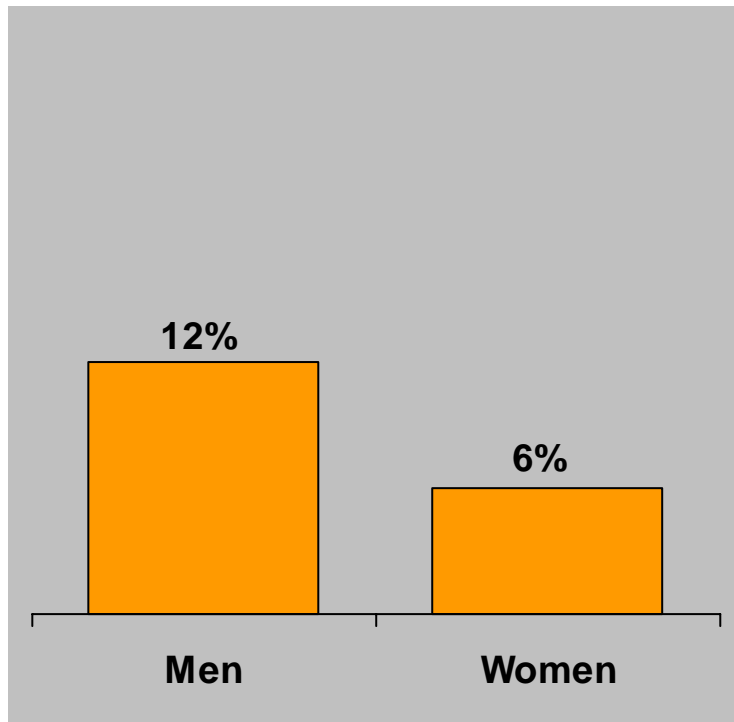
- Loss of liquidity
 - Partial annuitization still makes sense.
- Bequest motives
 - Again, partial annuitization makes sense.
- High fees
 - Research indicates that annuitants get back about 90% - 94% of their premiums. Is this sufficient return?

Barriers to annuitization (cont.)

- Adverse selection: Only those who expect to live for an extremely long time buy annuities
 - Medically underwritten annuities should resolve some of the adverse selection.
- Incentives in the industry
 - Advisors typically make less money if their clients buy an annuity.
- Risk sharing within the family
 - Do you really believe your kids will fund your retirement?

Behavioral barriers to annuitization: Financial literacy is extremely low

Percentage of people knowing what a money market fund is



Behavioral barriers to annuitization (cont.)

- Illusion of control: People love control even when it makes no economic sense
 - For example, 30% of state lottery players choose their own numbers.
 - And, many people who decline a free trip to the “Death Road” in Bolivia are willing to make the trip if they are in “control” (photos next).
 - Annuities, however, are perceived as providing very little control.





Behavioral barriers to annuitization (cont.)

■ Inertia

- After the switch to the joint-and-survivor default in DB pension plans, joint-and-survivor payouts among married men increased by over 25 percentage points.
- Lesson from auto-enrollment features in 401(k) plans confirms inertia is extremely powerful.
- Buying an annuity, however, requires taking action.

Behavioral barriers to annuitization (cont.)

- Regret aversion
 - Actions often generate more regret than lack of action.
- “Hyperbolic discounting” and de-annuitization
 - In the 1990s, over half of officers and over 90% of enlisted personnel took lump-sum distributions, implying discount rates of at least 18%.

Behavioral barriers to annuitization (cont.)

Annuities focus on the calculative self and often miss the intuitive / emotional self

The Calculative and Deliberative Self

Relatively slow

Demanding of cognitive capacity

Controlled

Analytic

Rule-based

The Intuitive and Emotional Self

Relatively fast

Undemanding of cognitive capacity

Automatic

Holistic

Associative

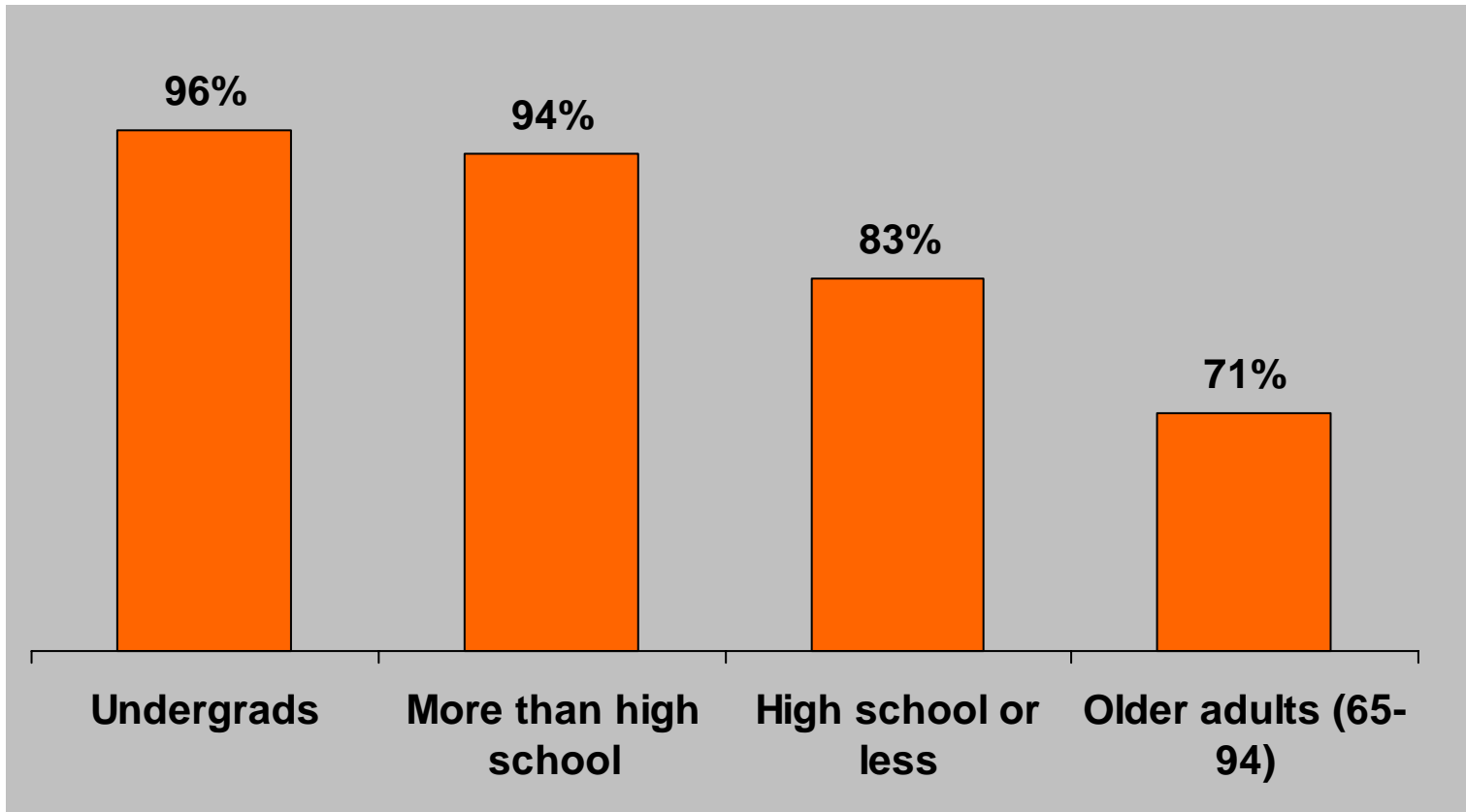
Furthermore, older people are not good with numbers and calculations

Consider the following question, posed to people of different age groups and educational backgrounds:

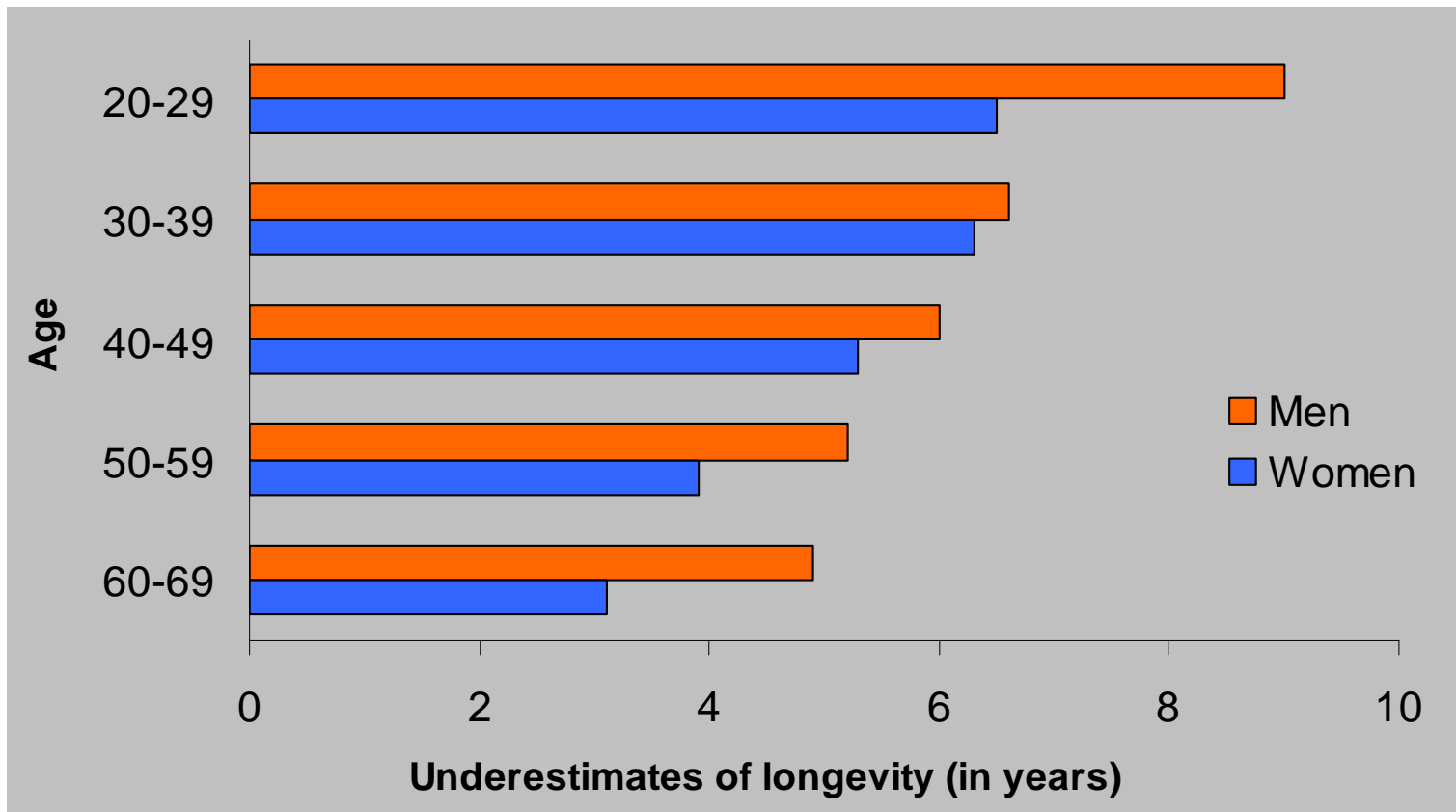
Which of the following numbers represents the biggest risk of getting a disease?

- A. 1 in 100
- B. 1 in 1,000
- C. 1 in 10

Percentage of people answering the question correctly



Behavioral barriers to annuitization: People underestimate longevity



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New products address today's concerns

- Premium refund annuities
 - “If you die, your heirs get your money back!”
- Deferred income annuities
 - Similar to dollar cost averaging.
- Mixed products
 - Offer partial annuitization.
- Longevity insurance
 - Payments received only if you live very long.

Will consumers buy these new products?

- While these products address some of the barriers to annuitization, the avalanche of new products could result in consumers and advisors being confused.
- Instead, maybe we should focus on making retirement income products available as well as educating participants about existing products.

How can we educate about annuities?

- Make retirement income products more accessible.
- Modify perception of annuities.
 - Relabel them as “Personal Pension Plans.”
- Use imagery to increase affective content of annuities.
 - People are willing to save more when they see an image of a house their savings could buy.

What is the US government doing?

- In the accumulation phase, encouraging “libertarian paternalism.”
 - In the US, the PPA encourages automatic enrollment and automatic saving increases.
- What about the decumulation phase, when people have reduced cognitive abilities?
 - The US government remains silent, and retirees are left on their own. In contrast, the UK government requires partial annuitization.

International comparison

	Options	Withdrawal Limits
Australia	<ul style="list-style-type: none">■ Lump sum, or■ Annuity, or■ Payments	<ul style="list-style-type: none">■ Minimum withdrawal■ No maximum
Canada	<ul style="list-style-type: none">■ Lump sum, or■ Annuity, or■ Payments	<ul style="list-style-type: none">■ Minimum withdrawal■ No maximum
US	<ul style="list-style-type: none">■ Lump sum, or■ Annuity, or■ Payments	<ul style="list-style-type: none">■ Minimum withdrawal■ No maximum
UK	<ul style="list-style-type: none">■ Mandatory annuitization at age 75 of at least 75% of account value	<ul style="list-style-type: none">■ <u>Maximum</u> withdrawal■ No minimum

Minimum payment calculations

- Minimum payment calculations are based on averages
 - Account value divided by number of years remaining (based on actuarial tables)
- What happens if you live much longer than average?

What do you think...

Should the government encourage annuitization (or other retirement income solutions)?

1. Yes
2. No

Summary

- Academic researchers have focused on the accumulation phase. Need more research on the decumulation phase.
- Efforts by the industry and plan sponsors need to be improved.
- The government can play a role in encouraging sponsors to help participants address longevity risk.

Thank you

If you have any comments or suggestions, feel free to contact me:
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