TIAA-CREF institute

TRENDS AND ISSUES

APRIL 2010

# RETIREES, ANNUITIZATION AND DEFINED CONTRIBUTION PLANS

Paul J. Yakoboski
Principal Research Fellow
TIAA-CREF Institute

## EXECUTIVE SUMMARY

The main objective for any primary employer-sponsored retirement plan is to provide its participants with an adequate and secure income stream throughout retirement. When that plan is a defined contribution (DC) arrangement, accumulating adequate assets is necessary, but not sufficient by itself, for achieving this objective. At least a portion of those assets must be converted to an income stream that lasts the duration of a retiree's lifetime. While other distribution strategies can provide income, annuitization is the only means to guarantee a consistent income stream that cannot be outlived. Annuitization rates, however, are low by any standard. Most participants in private sector 401(k) plans do not have the option to receive payments from their plan as annuitized income in retirement, though an individual always has the option to buy a payout annuity (often also called an immediate annuity) outside the plan with his or her accumulations. It's even less common for an annuity to be offered as an investment option for contributions and assets in a 401(k) plan during the accumulation phase.

Evidence indicates that investing in annuities during the accumulation phase of DC plan participation and the presence of a payout annuity option at retirement affect how retirees manage their savings for income, making them more prone to annuitize. A new survey has found that retirees who have annuitized their retirement savings are more than twice as likely, compared with retirees who have not annuitized, to have saved through an annuity in a DC plan while working. Twenty-four percent of retirees who have not annuitized their retirement savings participated in a DC plan that offered an annuity investment option in the accumulation phase, and 25 percent of these saved through the annuity. In comparison, retirees who have annuitized were only slightly more likely (29%) to have participated in a DC plan that offered an annuity

investment option; but among these, 45 percent saved through the annuity. Individuals are more prone to annuitize in retirement if they save through an annuity in a DC plan while working. In addition, 41 percent of retirees who annuitized participated in a DC plan that offered annuitization as a retirement payout option. By comparison, 28 percent of non-annuitants participated in a DC plan that offered the option to annuitize plan assets at retirement. In fact, one-third of annuitants purchased their payout annuity through a DC plan.

It is also apparent that professional advice matters. Over one-half of retirees who have not annuitized have worked with a financial advisor and most of these tend to follow the advice received. But only 5 percent were advised to annuitize. By contrast, 71 percent of annuitized retirees report working with a financial advisor in deciding to purchase an annuity or implementing the buy decision. Finally, there is no evidence of buyer's remorse with regard to payout annuities; 57 percent of annuitants are very satisfied with the decision to purchase a payout annuity and an additional 32 percent are somewhat satisfied.

## INTRODUCTION

Asset accumulation is necessary but not sufficient to ensure an adequate and secure retirement income. Managing savings in retirement and converting at least a portion of savings into a secure income stream are important considerations faced by retirees to ensure financial security. This is particularly true for those with significant accumulations in defined contribution (DC) plans and Individual Retirement Accounts (IRAs). A recent survey by the TIAA-CREF Institute found that two-thirds of near-retirees (age 50-70) in higher education are concerned about outliving their savings and about choosing the best way to draw income from their retirement savings.[1] In addition, 58 percent of higher education near-retirees considered it very important as they near retirement to receive advice regarding drawing income from retirement savings; an additional 29 percent viewed it as somewhat important.[2]

While other distribution options provide income, annuitization is the only means to guarantee a consistent retirement income stream that cannot be outlived. Annuitization rates are notoriously low, however.[3] Few private-sector 401(k) plans offer annuitization as a distribution option for retiring participants.[4] The use of annuities as an investment option in 401(k) plans during the accumulation phase is even less common.

To gain deeper insights into the decision-making of retirees regarding the management of their retirement savings and its conversion to income, the TIAA-CREF Institute surveyed individuals who have been retired at least 3 years, are not working for income during retirement, had $200,000 or more in DC and IRA assets at the time of retirement, and have less than $200 per month in defined benefit (DB) pension income.[5] Such individuals are more likely to be dependent upon their retirement savings for a significant share of their retirement income, thus their decisions regarding the management of that savings are especially important to their financial security. An equal number of individuals who have annuitized some of their retirement savings (referred to as "annuitized retirees" and "annuitants") and who have not annuitized assets[6] ("non-annuitized retirees" and "non-annuitants") were surveyed with unique sets of questions asked of each group.[7]

1 See Yakoboski, Paul J., "Converting Assets to Income in Retirement: What Near-Retirees are Thinking," TIAA-CREF Institute *Trends and Issues* (October 2009).

2 See Yakoboski, Paul J., "The Use and Impact of Advice among Near-Retirees," TIAA-CREF Institute *Trends and Issues* (February 2010).

3 For a complete discussion regarding the benefits of annuitization and an outline of reasons for low annuitization rates, see Brown, Jeffrey. "A Paycheck for Life: The Role of Annuities in Your Retirement Portfolio," TIAA-CREF Institute *Trends and Issues* (June 2008).

4 Twenty-one percent of private-sector plans offer an annuity as a retirement distribution option according to the *2008 Annual Survey of Profit Sharing and 401(k) Plans* (Profit Sharing/401(k) Council of America, 2009).

5 Over 90 percent of those surveyed have no pension income.

6 Specifically, individuals who are currently receiving regular payments from an immediate or payout annuity purchased when or after retiring. A payout annuity is defined as a financial product providing guaranteed income payments, typically for life.

7 One-hundred annuitants and 101 non-annuitants were survey by phone between November 30, 2009 and March 8, 2010. Sampling was designed to be representative of the respective populations.

## NON-ANNUITANTS

Many non-annuitized retirees appear uninformed regarding annuitization; one-third (34%) of non-annuitants report being not familiar with payout annuities and an additional 30 percent feel somewhat familiar with the product. Thirty-six percent of non-annuitants consider themselves very familiar with payout annuities.

Regarding the use and management of retirement assets accumulated in 401(k) plans, 403(b) plans and IRAs, 38 percent of non-annuitants report making withdrawals as needed, 31 percent take only the required minimum distributions and 26 percent make some form of regular periodic withdrawals (table 1). The likelihood of non-annuitants annuitizing assets at a future date is low; 68 percent report they are not at all likely to purchase a payout annuity in the future and an additional 21 percent are not too likely to do so.

### TABLE 1
### MANAGEMENT OF RETIREMENT SAVINGS BY NON-ANNUITIZED RETIREES

| | |
|---|---|
| Make withdrawals as needed | 38% |
| Take only the required minimum distributions | 31 |
| Make regular periodic withdrawals | 26 |
| Made no withdrawals to date | 12 |
| Make withdrawals only for emergencies or major purchases | 5 |
| Don’t know/refused to answer | 5 |

Note: Surveyed population is individuals who have been retired at least 3 years, are not working for income during retirement, had $200,000 or more in defined contribution (DC) and individual retirement account (IRA) retirement savings at the time of retirement, and have less than $200 per month in defined benefit (DB) pension income.
Source: TIAA-CREF Institute (2010).

Over one-half (57%) of non-annuitized retirees have used a professional financial advisor in deciding how to manage their savings during retirement and how to draw income from it. Advisors have an impact when consulted, with 71 percent of individuals following all or most of the recommendations received and an additional 24 percent typically following some of it. Only 5 percent of non-annuitants who used an advisor were advised to buy an annuity. Most commonly, the advisor helped select specific investments (29%) and discussed how much to withdraw and when (21%). Ten percent reported letting their advisor handle all management of their savings in retirement.

## THE ANNUITIZATION DECISION

The annuitization rate among retirees in the survey is 19 percent. This figure is likely higher than many might expect, but it must be considered in context of the surveyed population—retirees with significant DC and IRA accumulations ($200,000 or more), but insignificant pension income ($200 per month or less) —a group with a greater likelihood of needing the savings to provide regular income. Satisfaction levels among annuitized retirees are high. Over one-half (57%) of annuitants are very satisfied with the decision to purchase a payout annuity and an additional 32% are somewhat satisfied; 6% are not satisfied, with 5% not responding.

Income-related reasons were most typically cited for purchasing a payout annuity; 27 percent of annuitized retirees cited the regular monthly income, 16 percent cited income that is guaranteed for life and an additional 8 percent annuitized to supplement other income and investments (table 2). In addition, 22 percent of annuitants said that a payout annuity seemed like a good, safe investment for retirement.

While only 3 percent of non-annuitants were advised to buy an annuity (5 percent of the 57 percent who used an advisor, see above), 21 percent of annuitants reported that an advisor told them to purchase an annuity, indicating that the recommendations of an advisor do influence an individual retiree’s decision.

**TABLE 2**
**REASONS FOR PURCHASING A PAYOUT ANNUITY**

| | |
|---|---|
| For the regular monthly income | 27% |
| Seemed like a good, safe investment for retirement | 22 |
| An advisor said to purchase an annuity | 21 |
| For income that is guaranteed for life | 16 |
| No choice since the annuity was provided by their employer | 9 |
| To supplement other income and investments | 8 |
| Secure investment that won't lose money | 4 |
| Other reasons | 5 |
| Don't know | 9 |

Note: Surveyed population is individuals who have been retired at least 3 years, are not working for income during retirement, had $200,000 or more in defined contribution (DC) and individual retirement account (IRA) retirement savings at the time of retirement, and have less than $200 per month in defined benefit (DB) pension income.
Source: TIAA-CREF Institute (2010).

Two-thirds (64%) of annuitants report annuitizing less than one-half of their retirement assets; 38 percent annuitized less than 25 percent of their assets and 26 percent annuitized between 25 and 50 percent. In addition, 12 percent annuitized 50 to 74 percent of their retirement savings and 6 percent annuitized 75 percent or more; 18 percent did not report the fraction of retirement assets that were annuitized.

Almost one-half (47%) of annuitized retirees have a single payout annuity from which they receive income. Twenty-seven percent of annuitants receive income from two annuities and 13 percent from 3 or more; 13 percent did not report the number of payout annuities owned. Owning a fixed payout annuity (53% of annuitants) is more common than owning a variable payout annuity (26%); 21 percent of annuitized retirees have both a fixed and a variable. Eighty-two percent of married annuitants[8] report that they own a joint and survivor annuity, thus providing an income guarantee for a spouse in the event of the annuitant's death.

## ANNUITIZATION, ANNUITIES AND DC PLANS

Twenty-four percent of retirees who have not annuitized their retirement savings participated in a DC plan that offered an annuity investment option in the accumulation phase, and 25 percent of these saved through the annuity. In comparison, retirees who have annuitized were only slightly more likely (29%) to have participated in a DC plan that offered an annuity investment option; but among these, 45 percent saved through the annuity. So, retirees who have annuitized their retirement savings are more than twice as likely, compared with retirees who have not annuitized, to have saved through an annuity in a DC plan while working.

Forty-one percent of annuitants participated in a DC plan while working that offered the option to use some or all of their plan assets to purchase a payout annuity when they retired. By comparison, 28 percent of non-annuitants participated in a DC plan that offered the option to annuitize plan assets at retirement.

These findings indicate that investing in annuities during the accumulation phase of DC plan participation and the presence of a payout annuity option at retirement increase the likelihood that individuals will annuitize retirement savings. One-third (32%) of annuitants reported purchasing their payout annuity through a DC plan, which means that almost 80 percent of annuitants offered an annuity payout option used it to purchase their annuity. Only 4 percent of non-annuitants report that they very likely would have annuitized at least some assets if the option had been available through a DC plan, with an additional 14 percent somewhat likely; these figures slightly exceed the percentage reporting that they are now likely to purchase an annuity at a future date.

8 Sixty-five of the 100 annuitized retirees in the survey were married.

## CONCLUSION

Nineteen percent of individuals who retired with significant accumulations in defined contribution (DC) plans and IRAs, but little defined benefit pension income, have annuitized at least some of their retirement savings. Investing in annuities during the accumulation phase of DC plan participation and the presence of a payout annuity option at retirement increase the likelihood that a retiree will annuitize savings. Retirees who have annuitized their retirement savings are more than twice as likely, compared with retirees who have not annuitized, to have saved through an annuity in a DC plan while working. It is also apparent that the use of an advisor and the advice received matter when deciding how to manage savings during retirement. While only 3 percent of non-annuitants were advised to buy an annuity, 21 percent of annuitants reported that an advisor told them to purchase an annuity.

## ABOUT THE AUTHOR

Paul Yakoboski is a Principal Research Fellow with the TIAA-CREF Institute. He conducts, manages and communicates research on issues such as income and asset management in retirement, defined contribution plan design, the preparation of higher education faculty for retirement, managing faculty retirement patterns, options for funding retiree health care, and research on issues related to strategic management in higher education. He is also responsible for the development and execution of Institute symposiums on such issues. In addition, Yakoboski serves as director of the Institute's Fellows Program and editor of the Institute's *Trends and Issues* and *Advancing Higher Education* publication series.

Prior to joining the Institute, he held positions as Director of Research for the American Council of Life Insurers (2000 to 2004), Senior Research Associate with the Employee Benefit Research Institute (1991 to 2000) and Senior Economist with the U.S. Government Accountability Office (1989 to 1991). He is a member of the American Economic Association and serves on the editorial advisory board of Benefits Quarterly. He previously served as Director of Research for the American Savings Education Council (1995 to 2000). Between 1986 and 1988 he served as an adjunct faculty member at Nazareth College. Yakoboski earned his Ph.D. (1990) and M.A. (1987) in economics from the University of Rochester and his B.S. (1984) in economics from Virginia Tech.