The Market for Retirement Financial Advice

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Chapter 7

The Role of Guidance in the Annuity Decision-Making Process

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Some of the most important decisions that employees and retirees ever make pertain to evaluating lifetime income streams and deciding how to draw down their retirement incomes. Yet because these decisions involve complex trade-offs that are often poorly understood, most people would benefit from guidance. This chapter reviews the roles of plan sponsors, plan administrators, advice providers, and public policy surrounding the decision to buy annuities as payout vehicles providing lifelong income. We examine how these roles can be handled using an institutional platform offering structural and active guidance in the purchasing process. This system requires informing individuals about available options, designing websites for presenting information and education, and purchasing through a competitive bidding process. Active guidance involves information provided by salaried professionals who answer questions and have conversations with individuals about the annuity purchase process. We draw for our analysis on the experiences of Income Solutions®, Hueler Companies' institutional purchasing platform in the United States (Hueler, 2012). We also draw lessons from experiences in Chile and the United Kingdom.

Setting the stage

In the past, employees in the United States tended not to receive much guidance about how to handle their retirement assets. If advice was offered, it was normally relegated to at or near retirement, and rarely did employers offer advice about annuitization, or the conversion of retirement assets into a lifetime income stream. Now that defined contribution (DC) plans are more common, most (except for money purchase pension plans) tend not to offer annuity payouts, and if annuities are not offered through the plan, retirees traditionally have gone to the retail market to purchase annuities. Yet annuities can also be offered through an institutional purchasing platform

(discussed in more detail below) that can bring the benefits of group purchasing to individual retirees.

If people do not annuitize, they may take a structured or phased withdrawal from their investment portfolios, and then they have no lifetime protection against running out of money. Some favor the '4 percent rule,' where the retiree can spend 4 percent of the initial asset balance annually, perhaps with the withdrawal amount increased by inflation each year. Many financial advisors and advice providers,[1] particularly those who offer managed accounts, tend to favor such a structured withdrawal approach over the use of lifetime income annuities during the paydown phase. This bias exposes the retiree to both investment and mortality risk. Some advice providers have begun promoting late-in-life deferred annuities that begin payments at ages 80 to 85 to address longevity risk, but they still discourage the use of lifetime income annuities earlier in the drawdown phase.

US policy toward retirement payouts has been of two minds, in that some efforts have promoted annuitization, while others discouraged it. For instance, social security benefits are an inflation-indexed lifetime income stream, and defined benefit (DB) pensions also traditionally provided lifetime income. By contrast, funds in Individual Retirement Accounts (IRAs) or DC plans other than money purchase plans are generally not annuitized (Rappaport, 2011). As shown by Turner and Muir (2013), the time of rollover is one of several situations when 401(k) plans are vulnerable with regard to potential conflicts of interest. There is also no requirement to provide employees or retirees with information on payout strategies or options beyond what is provided by the plan, and there is also no requirement to provide information about the possibility of lifetime income while plan assets are being accumulated. Some legislators have recommended including illustrations of lifetime income streams as well as account balances in the DC accounts, but this practice has not been widely adopted (United States Senate, 2011).

The US Internal Revenue Code allows contributions to and investment earnings in employer-sponsored pensions to benefit from tax deferral, until the age of 70 and a half. Thereafter, the Required Minimum Distributions (RMD) rule requires that people withdraw at least a minimum amount from their tax-deferred accounts each year, in order to limit tax deferral. This minimum is calculated to spread withdrawals over the retiree's life expectancy, and the withdrawal fraction is recalculated each year. Because the RMD provides for gradual withdrawals, it takes the focus away from annuitization and other income options for people who do not need to withdraw more from their qualified funds. For this reason, it has come to be viewed as a recommendation or guidance offered by policymakers on about how to spend one's funds. One problem is that an individual who takes the RMD each year will have continued growth in

funds when investment returns are high, but will deplete his assets too rapidly when markets are low. As a consequence, the individual could run out of money too soon.

It has also been difficult for pension plan sponsors to offer annuity options, since regulations often impose barriers and create legal risks (Iwry and Turner, 2009). Proposed regulations and two revenue rulings issued in 2012 by the United States Treasury Department sought to remove some of the barriers and make it easier to offer lifetime income options to participants in certain instances. The new proposals sought to (*a*) move away from the idea that choice of distribution option in employer-sponsored DB and DC plans must be an all-or-nothing decision; (*b*) remove the barriers to the use of advanced life deferred annuities that arise from the structure of the RMD requirements;[2] (*c*) clarify that DC sponsors who also have DB plans may permit participants access to lifetime income through rollover of DC funds into DB plans;[3] and (*d*) make it easier for DC plan sponsors to include deferred annuity options as plan investments prior to retirement (United States Department of the Treasury, 2012). There has also been US Department of Labor regulation requiring the disclosure and explanation of all DC plan fees. These changes are signaling to plan sponsors and the broader population how important it is to have lifetime income and transparency (Council of Economic Advisers, 2012). These developments reflect new support for lifetime income plans using qualified retirement plan assets.

Even if these initiatives are positive, the state of the regulatory environment remains complex. US employer-sponsored retirement programs are regulated by the Federal government, while insurance contracts are regulated by separate state insurance departments. Moreover, the annuity sales process includes a requirement for a suitability review when individual annuity contracts are sold, and the standards are evolving. In 2010, the National Association of Insurance Commissioners (NAIC) adopted the 'Suitability in Annuity Transactions' model regulation seeking to set up a regulatory framework holding insurers responsible for ensuring that annuity transactions are suitable. This approach also required training for agents, and where feasible, coordinated standards with requirements of Financial Industry Regulatory Authority (FINRA; see NAIC, 2010). Some might see this suitability review process as a form of guidance.

Guidance and the annuitization decision

In the United States, pension participants receive signals on strategies for asset drawdowns from many sources. Information can be provided by the plan sponsor, the plan's architecture, the media, an advisor or financial services firm, guidance during the annuity purchase process, and government via

policy and regulation. As discussed below, such guidance can either support or discourage annuitization.

US DB plans must offer annuities as the default distribution option, so here plan architecture imparts strong signals about the importance of lifetime income. By contrast, most DC plans pay out lump sums that are often rolled over to an IRA. Currently, only about one-fifth of DC plans offer in-plan annuity options, and these are rarely utilized even when offered (Wray, 2008).[4] The 2012 Treasury releases may change how DC balances are used, inasmuch as these assets now may be rolled over to DB plans to provide lifetime income. A complementary model to this idea is to offer participants who roll their funds to an IRA access to a favorable purchasing program for annuities as part of the employer-sponsored program design. At least one large plan is currently offering such an approach, giving participants the alternative of moving DC funds to DB and the choice of using DC funds to find the best customized arrangement from the private market. Structural guidance in this case would include basic education about lifetime income, information about specific annuity options provided, and the pros and cons of each option.

Another example of plan architecture that highlights lifetime income offers workers an option to buy lifetime income on a deferred basis, as one of the plan's investment options. Several insurance companies offer products to support such options, some using a fixed annuity, and some using a variable annuity. The variable annuity options guarantee floor benefits and offer upside potential through the use of a guaranteed minimum income benefit or a guaranteed minimum withdrawal benefit. The options have important differences with regard to portability and guaranteed provisions. With these options, plan assets are invested during the working years in a fund that offers lifetime income in retirement (Institutional Retirement Income Council, 2011). These models blend features of traditional group deferred annuity products with newer investment structures. Under these models, the individual has no choice of insurance company and is limited to the choice of payment forms embedded in the plan architecture. As yet, the modern versions of this model have been adopted by few employers so it remains to be seen how effective they will be.

To date, the role of the employer in supporting and encouraging the use of lifetime income alternatives has been limited. Some plans have begun to offer education around lifetime income and access to institutionally priced annuities. As shown in Table 7.1, according to a Plan Sponsor Council of America survey, about one-third of employers provide access to an employer-selected financial planner or offer a seminar regarding retirement assets and income planning (Wray, 2008). Nevertheless, it is not known whether much information about annuities is provided, or whether the messages favor or discourage consideration of annuitization. Moreover,

Table 7.1 Types of retirement guidance or education provided by companies to their employees

Percentage	Type of education
11	None, except notices required by law
34	Access to an employer-selected financial advisor
78	Provides educational materials explaining plan options
68	Offers retirement income calculator online
31	Offers seminar regarding retirement assets and income planning

Source: Derived from Wray (2008) using a 2008 survey of Profit Sharing Council of America (now Plan Sponsor Council of America) members.

the choice of options to be presented and how they are positioned may be impacted by the products and services offered by the firm conducting the seminar, as well as the compensation model. Of survey respondents, 5 percent indicated that they actively encouraged retirees to leave their accumulations in the plan, 11 percent required or encouraged withdrawal, and the remaining 84 percent were ambivalent (Wray, 2008).

When they do not offer access to annuities directly through the plans, some employers do provide access to institutionally priced annuities through a purchasing platform such as Income Solutions®. This platform is most often utilized as an IRA rollover alternative. In such cases, structural guidance varies widely: some regularly mention the availability of the annuity purchasing option, while others provide little or no information about the program. In addition, some employers make the program visibly prominent at the benefits portal and facilitate easy access, while others bury the offering in the benefits website, making it difficult to locate and access.

In our experience, the employer representative (either in-house or at the record keeper) is the first point of contact regarding information at the time of retirement plan distributions. How the process of such participant communication is designed has a potent impact on what alternatives retirees elect to explore. Very few employers offer education emphasizing the importance of lifetime income and the value of annuitization, though if, over time, a plan sponsor does explain such benefits in newsletters or employee publications, this drives an increase in annuity quotations, inquiries, and ultimately purchase activity. In other words, such an approach can take several years to take hold, but it does produce increased activity with time. On the other hand, experience across multiple program partners suggests that even when a plan sponsor encourages consideration of annuities, the primary driver behind purchasing behavior is whether the benefits representative is objective and knowledgeable about retirement distribution options. If the benefits representative dissuades participants

from utilizing the competitive platform, or annuitizing a portion of their balances, or steers the participant to a proprietary higher cost alternative, this can trump employer efforts.

Many employers today offer advice to their DC plan participants; in fact, a recent survey indicated that 79 percent of plan providers offered their employees some type of investment advice (Callan Investment Institute, 2012). An advice provider may be an independent third party or affiliated with the plan administrator, and such advisors generally seek to help employees save more and make better investment decisions. Since plans differ with regard to whether they encourage or permit leaving funds in the plan post-retirement, and what options they offer, naturally the advice providers will also differ as to whether they supply information and advice for the payout period, what advice they provide, and how they help people transition to the payout period. In our experience, some advice providers do discuss a wide array of post-retirement options including annuitization and explain the options well, but others clearly discourage annuitization as part of a drawdown strategy and instead seek to keep the funds in a managed account using a structured payout or systematic withdrawal method. This is important since the conversations taking place around retirement are likely to have a major impact on retirees' distribution strategies.

Employers also build expectations about the importance (or lack thereof) of retirement income by how they depict retirement plan account values during the working years. Some show only the account balances, whereas others include retirement income projections.[5] Callan Investment Institute (2012) recently indicated that 58 percent of employers offered or provided retirement income projections for participants; of these, 31 percent showed them on the employee statements, 13 percent provided the information through a separate mailed statement, 74 percent provided access to a calculator on the benefits website, and 15 percent provided the projection through a third party advice provider. More research is required to better understand the range of practice in such statements and projections, and their impacts on later decisions about lifetime income and structured payouts.

An institutional purchasing platform and guidance

Plan sponsors can elect to offer an institutional purchasing program for lifetime incomes, via an Internet-based competitive bidding platform for immediate and deferred income annuities. This platform has two primary modes for implementation: as a distribution option within the plan, or as an IRA rollover alternative. To date, the most common method—with over 90 percent of programs implemented—is the IRA rollover alternative. The

platform relies on participating insurance companies' willingness to offer annuities through a low-cost competitive distribution channel.

Within the various program partner offerings, the individual purchaser may learn about annuities through general financial education, basic annuity education provided on the website, employer-provided information about the programs, or through facilitators or advisors. The system architecture offers structural online guidance and information to support a self-service model, including general annuity education, educational videos discussing the importance of inflation-adjusted annuitization, tools for calculating gaps between other sources of income and regular expenditures to establish income levels needed, standardized competitive annuity quotes across multiple issuers, and information about the financial status of the participating insurance companies. The structural guidance does not recommend whether to buy an annuity or how much to buy; instead the program is designed to educate individuals about annuity options, lower costs, standardize fees, create transparency, and produce the best possible market result for each individual. There is no incentive to use one annuity provider versus another, or to constrain individual purchase decisions.

Access to program and guidance models

Access to the platform occurs mainly through a retirement plan sponsor, a program partner such as a financial services firm, a record keeper, an association, or through an advisor linked to the program. The partner plays a critical role in setting the stage for consideration of lifetime income alternatives (or, as noted above, in effectively foreclosing such options). Programs that offer a menu of alternatives and integrate annuitization into the discussion not just for those on the verge of retirement but also after retirement show the highest level of annuity purchase activity. By contrast, if a program presents onerous disclaimers and/or uses an advice provider who discourages annuitization in the drawdown phase this creates the highest user drop-off rate.

The platform also provides individuals with access to active personal guidance. This can range from basic assistance to more in-depth advice, depending on the program partner. Currently, most programs do not offer comprehensive financial planning or advice; rather, active guidance is delivered through licensed salaried professionals able to talk with individuals about options accessible through their employers, and/or additional lifetime income alternatives available to them through their personal IRA.

Table 7.2 shows how the delivery of guidance differs across the program models. Three models of guidance are available.

Table 7.2 Comparison of structural and active guidance in institutional platform delivery models through different channels

Element of purchase process	Institutional individual	Institutional facilitator	Institutional advisor
Structural guidance			
Information provided about program availability	Program partner	Program partner	Advisor
Who secures quote	Individual	Facilitator or individual	Advisor
Who executes purchase	Individual	Facilitator or individual	Advisor
How platform impacts decision to annuitize	Provides information about value of annuity and considerations—text and video on website	Facilitator may add to what is on website, but limits discussion to pros, cons, and issues vs. recommendations	Depends on how it is used by advisor
Issues to be considered and pros/cons provided	By website	Additional information may be provided by facilitator; depends on program partner	Depends on advisor
Tools provided	Yes, competitive quote, insurance company ratings, tool to calculate income gap	Yes, how much additional beyond program platform depends on program partner	Advisor may provide evaluation or offer tools beyond program platform
Universe of insurance carriers providing annuity quotes[a]	Platform does this automatically	Platform does this automatically	Platform does this automatically
Can individual access website directly	Yes	Yes	No
Active guidance			
Who answers individual questions	Help center or staff	Facilitator	Advisor
Recommendations provided	No	No	Yes

[a] Participating insurance carriers may vary depending on program partner, annuity type, and employee demographics such as state of residence.

Source: Authors' analysis; see text.

Online direct to individual

Here access is by the individual who initiates the quote and purchase process through an online platform. This program includes structural guidance with general information about immediate annuities, an explanation of the benefits of institutional purchasing, a calculator to help the individual estimate the gap between existing income and expenses, and a place for requesting annuity quotes online. Individuals can telephone the help center with questions and are provided basic assistance. Callers are provided with active guidance in the form of assistance to help them use the online platform and answers to questions regarding annuity terminology, features, and the purchase process.

Facilitated

Here active guidance is provided through partnerships offering additional professional assistance through a facilitator: salaried and licensed professionals help participants submit requests for quotations, consider the purchase, answer questions, and submit purchase requests through the platform. Such facilitators may communicate with individual buyers by telephone or e-mail; they are typically employees of the program partner who specialize in annuities and income alternatives for retirement. In some transactions, the facilitator does all of these steps, while in others, the participant secures quotes or places transactions, while the facilitator provides some assistance. The system has an interactive design so that facilitators and individuals can both review annuity quotes at the same time.

Advisor

Here the advisor provides broader financial advice, including advice about the individual's overall portfolio; in this case, the expert would initiate the discussion. Advisors using this program are normally fee-based advisors paid by the client; their job is to secure quotations, explain the options to the client, advise them regarding the best annuity option, and in some cases make the annuity placements.[6]

Table 7.3 compares the guidance models with individual purchase and DB plan elections. Here we see that DB plan elections have a fixed period when the election must be made; all the other purchase models allow flexibility with regard to when the annuity purchase can take place and features that can be selected. These models differ with regard to how the contact is initiated, the options available, the timing, and the type of guidance that is offered. The three models in the institutional purchase

Table 7.3 Obtaining annuity income through retail purchase, institutional purchase, and/or DB payout

Characteristic	Retail[a]	Institutional individual[b]	Institutional facilitator[c]	Institutional advisor[d]	Annuity as a DB payout
Contact re-purchase of annuity	Agent	Self	Facilitator, seen as affiliated with plan and hired by program partner	Advisor, hired by buyer	Plan sponsor or administrator
Pricing	Retail	Institutional	Institutional	Institutional	Defined in plan
Competitive quotes	Maybe	Yes	Yes	Yes	NA
Fee disclosure	Maybe	Yes	Yes	Yes	NA
Fee level	Retail	Institutional	Institutional	Institutional	NA
Timing constraints	No	No	No	No	Yes
Initial communication	Usually agent	Plan or program partner	Plan or program partner	Advisor	Plan sponsor
Initiator of first step	Usually agent	Self or help center staff	Self or program partner	Advisor	Plan sponsor must follow plan

[a] Applies to purchase by the individual in the retail insurance market, usually using an agent.
[b] Applies to purchase through the institutional purchasing platform, where the individual directly uses the platform after an introduction by the program partner.
[c] Applies to institutional purchasing platform where a facilitator, or salaried representative of a program partner, assists in the purchase and secures quotations, answers questions, and executes the purchase.
[d] Applies to situations where an advisor initiates the contact and executes on behalf of their client.

Source: Authors' analysis; see text.

platform are similar except for the content and method of active guidance and the method of initiation of the discussion.

Table 7.4 shows how the annuity purchases differ depending on the delivery channel used. It must be noted that the groups purchasing through different channels are not necessarily similar demographically or by wealth levels; we do not yet know the reasons for the observed differences by channel. Individuals purchasing directly via the online platform have the highest average premium, are heavily male, and are most likely to select a joint life annuity; they also consider the purchase for quite a while and request multiple quotes. Those purchasing through facilitators tend to have several conversations before securing quotations, suggesting consideration of needs prior to obtaining quotes. Our analysis of purchases where active guidance was available showed an average of five calls per purchaser (and a

Table 7.4 Characteristics of annuity purchasers and what they purchased through different channels

	Total across all channels	Institutional individual	Institutional facilitator	Institutional advisor
Average amount of premium	$139,000	$158,000	$142,000	$50,000
Female (%)	37	25	40	49
Male (%)	63	75	60	51
Joint life (%)	37	47	31	53
Single life (%)	50	40	55	46
Fixed period only (%)	13	13	14	1
Buying within two weeks of first quote (%)	63	50	70	53
Buying within four weeks (%)	78	67	83	69
Buying within six months (%)	94	90	98	81
Buying after six months (%)	6	10	2	19

Source: Authors' analysis of data provided by the Hueler Companies.

maximum of fourteen). Those purchasing through advisors had the lowest premium per single purchase and a greater number of individual purchases, perhaps reflecting the positioning of the annuity in their portfolios. Advisors and their clients are more likely to view the purchase as part of a longer-term lifetime income planning process, whereas a facilitator tends to act as a specialist dealing with the client specifically on the annuity decision.

Structural guidance and decision-making

Individual purchasers of annuities have many choices to make, including when to buy, how much to buy, whether to make multiple purchases, which carrier(s) to choose, and what forms of annuity to take. Accordingly, the competitive quotes provided on the platform include multiple carriers, the form of annuity requested as well as alternatives, and the financial rating information of all the insurance carriers. All quotes are standardized to allow for straightforward comparability. Nearly all purchasers choose to get multiple quotes before completing a purchase. Four is a typical number of quotes for those making a single purchase, but ten is a typical number for people making multiple purchases. Some of the variations that can be tested using multiple quotes include single versus joint life, joint life switching which spouse is primary, joint life with different percentages to the survivor, premium amounts, and the date when the annuity income will

commence. Pricing is provided in real time. The competitive quote process is designed to be transparent and it includes comparable product features from different carriers and parallel information, offering a form of structural guidance. By including not only the income that can be provided but also the financial rating of the carriers, the approach highlights the importance of the insurance company's financial status.

Suitability reviews and guidance

As part of the purchase of an immediate annuity contract, the purchaser must complete a suitability form. While the specific forms may differ by insurer, data required include information to determine suitability. According to the NAIC: '"Suitability information" means information that is reasonably appropriate to determine the suitability of a recommendation, including age, annual income, financial situation and needs, financial experience and objectives, intended use of the annuity, financial time horizon, existing assets, liquidity needs and net worth, risk tolerance and tax status' (NAIC, 2010: 4). While this process is designed to provide consumer protection, it can be viewed as guidance as well and each insurer has forms and specific definitions of financial information to be reported.

The institutional purchasing platform includes suitability review as part of the purchase process, and a checklist is used for a systematic approach. Examples of flags that would prompt further review, and in some cases, a confirmation contact with the applicant for the annuity include: relatively large annuity purchase compared to assets, a single life annuity without refund or a certain period, a purchaser over age 80 or younger than age 59.5, and insufficient financial information on the suitability form. After the reviewer looks at the financial situation and reasons for purchase, there may be a follow-up contact if required.[7] The suitability review process serves to confirm that the buyer understands their purchase decision and that the sale is appropriate. An interview with a reviewer indicates that buyers rarely change their minds as part of the suitability process.

Experience with guidance models

Many facilitators are salaried employees of program partners, and Hueler has licensed employees who can answer questions for purchasers, partner employees, or advisors. In some situations, the facilitators initiate the process of securing a bid, and make a purchase; in others, they simply answer questions. Experience has shown that the conversation is a very important element in influencing purchase activity. Thus, 72 percent of the purchases in our analysis occurred via facilitators and advisors; the

remaining 28 percent of the purchases occurred online, but here too, some people also ask questions after contacting their program partner's help center. Very few individuals buy an annuity without a conversation—probably fewer than 10 percent of purchasers—and many people request multiple bids and multiple purchases.

In the past, the decision about whether to purchase lifetime income annuities in an employer-sponsored arrangement assumed purchase would occur just when the employee was retiring, and it was presented as an all-or-nothing decision. Yet this approach does not conform well to peoples' preferred decision-making approach. In our experience, 70 percent of the annuity purchases were made by individuals who identify themselves as already retired. People prefer to make annuity purchases over a longer time period, since moving into retirement can require a period of transition and adjustment. Some need time to see how much they will be spending and how much more regular income they need; others seek to work part-time and it may take time to see how this affects their needs. Others change their living arrangements and housing. It also makes sense to phase purchases over time in order to diversify interest rate risk. As a consequence, offering an immediate annuity purchase as an irrevocable decision and an all-or-nothing option is likely to be rejected. The institutional choice platform is one alternative for moving away from the old unsuccessful delivery model.[8]

Immediate annuity buyers

An analysis of purchases drawn from the Hueler platform database indicates that about two-thirds of the immediate annuity buyers are men. The most common age for purchase is in the 60s (56 percent) but some purchasers are as young as age 50 and others as old as 85. Thirty-two percent are aged 70+, including 8 percent who are aged 80+. Seven percent of the immediate annuity purchasers reporting their net worth on the coded sample of suitability forms indicated having a net worth of under $100,000; 27 percent indicated net worth of $500,000–$1,000,000; 21 percent had $1,000,000–$2,000,000; and 14 percent said they had over $2,000,000. While financial profile questions vary, they do not include home equity, and wealth data are self-reported. Sixty-eight percent of the purchases are from tax-qualified assets,[9] either IRAs or DC plans; 28 percent are from non-qualified assets; and 4 percent are exchanges under Section 1035 of the Internal Revenue Code.[10] Exchanges are existing annuity contracts—often variable annuities—that are exchanged for immediate annuities purchased through this platform. Some purchasers use a combination of qualified and non-qualified funds to purchase multiple annuities.

Table 7.5 Characteristics of single premium immediate annuities purchased: amounts of income purchased and annuity features chosen

Type of annuity	Percentage of total purchases (%)	Average monthly income purchased ($)	Percentage of total purchases with inflation protection or fixed annual increases (%)	Percentage purchased by male buyers (%)	Percentage purchased by female buyers (%)
Joint life					
With cash refund	7	900	10	78	22
Life only	14	973	8	75	25
With term certain	17	799	23	87	13
Total joint life	37			81	19
Single life					
With cash refund	9	789	10	53	47
Life only	28	803	18	51	49
With term certain	13	843	13	45	55
Total single life	50			50	50
Fixed period only	13	1,032	3	65	35
Total of all contracts	100		14	63	37

Source: Authors' analysis of data provided by the Hueler Companies.

Table 7.5 provides a closer look at annuity purchases. Structural guidance included in the system provides that in addition to the requested quote, at least one alternative quote is presented. Many immediate annuity buyers (50 percent) purchase single life annuities; another third (37 percent) buy joint life annuities; and 13 percent buy period certain annuities. Only 14 percent of those buying immediate annuities purchase products with inflation protection, either consumer price index (CPI)-linked or annual percentage increases. We also see that men and women select different types of annuities: 81 percent of the joint life annuities are purchased by males, compared to only 50 percent of the single life annuities. It is likely that in married couples, the husband would be designated as the purchaser more often than the wife.

While the amount of income purchased averages over $850 per month, many purchases are for smaller amounts: 11 percent bought less than $200 monthly; 18 percent bought $200–$399 per month; and 22 percent $400–$599. Fifty percent purchased less than $600 per month, 22 percent from $600 to $999, and 28 percent more than $1,000 in monthly income. Women purchased lower amounts, averaging $110,000 of premium versus $156,000 for males. While the vast majority of buyers make a single purchase at a time, some do make multiple purchases (however, the purchase

data shown here are based on single purchases; multiple purchases are not aggregated).

Timeline from quotes to purchase

Whereas a DB plan election must be made within a specified time window and the price of various options is part of the DB plan design, the annuity purchase process is very different when individuals utilize the institutional platform.[11] The buyer can choose when to purchase, what to buy, and can make the decision over a long period of time. People can buy annuities with different features and monthly income benefits, and they can obtain multiple contracts. In our experience, many buyers secure multiple quotes; though 78 percent of purchases are completed within four weeks of the initial quotation, some people take as long as two years to move from the initial quote to purchase.

Competition, issuer selection, and fee disclosure considerations

On the institutional platform, competitive bidding is used for all annuity quotations. Experience reviewing quote data shows that, at any given point in time, different individual issuers will be competitive for different quotation scenarios, and quote results also change over time. Differentials between results for individual quotation scenarios may be due to insurance carrier views of specific annuity features, demographics, underlying pricing assumptions, market conditions, and timing.

Our analysis of several thousand annuity quotes indicates that, on average, the difference in monthly income between the high and low quote averages 8 percent; in some instances, it may be as much as 20 percent though spreads greater than 15 percent are rare. Our analysis also examined individual issuers' positions on annuity quotes relative to peer companies, illustrated in Figure 7.1. Here we report a sample of fifty individual quotations, each with a $100,000 annuity purchase price; one specific insurance carrier's quote position is plotted against multiple peer companies across different annuity types over a twelve-month period. Each vertical line in the figure represents the range of the high to low annuity quotes across the various providers for each annuity quotation scenario. The box represents the same individual insurance carrier across each quote scenario. In the period shown, this carrier had the high result for some quotes and the low result for others; it was in the middle range for the remaining cases. Similar results have been found consistently over time. The size of the spread between the high and low quote varied by scenario.

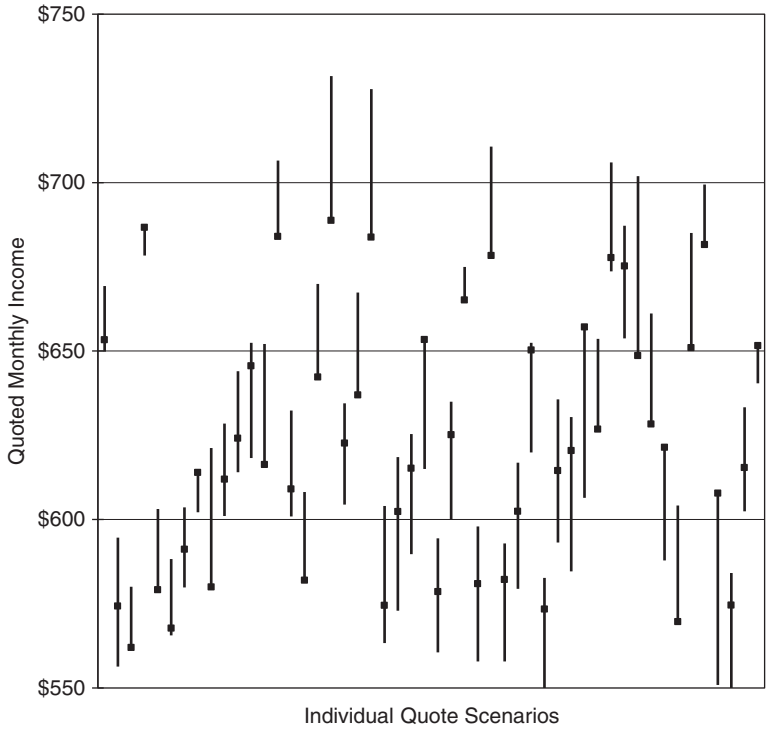

Figure 7.1 Annuity quotes for a $100,000 deposit over one year

Source: Authors' analysis of data provide by the Hueler Companies.

To put results in context, the spreads are not as large as those found in the United Kingdom (Reyes and Stewart, 2008).

Handling questions and concerns

Some program partners have support staff to answer questions and assist with the purchase process, while others directly approach Hueler Companies staff. Some common questions are about process: How to access the live quotes and what happens during the quote/purchase process? Another common question is 'How much should I annuitize?' Individuals who ask this question are directed to the 'income gap' calculator at the website that helps them consider other sources of income and categories of typical expenses, and the difference between essential and discretionary expenses is also explained. Another common question is whether there are any fees involved in the program. The institutional platform embeds a flat

one-time transaction fee in quotes for all purchases. Fees are fully disclosed to the individuals before and after purchase, which may generate additional questions (as this differs from other annuity delivery models). Buyers also often ask questions about providing survivor benefits and inflation protection.

Other commonly asked questions are about insurance companies and include how many insurance companies are available to choose from. This number can be as many as ten, depending on the annuity features requested and the program partners to which they are linked. Buyers also commonly ask how insurance companies are chosen and what the differences are between companies. They are directed to the location on the website that provides information about the companies used and their financial conditions, including ratings from Moody's, Standard & Poor's, and A. M. Best. Some annuity buyers as well as program partners are very aware of the issue of insurer insolvency and ask about this issue. Some buyers split the purchase between multiple insurance carriers to diversify insurance carrier risk. Plan sponsors who offer access to any form of annuity product or platform whether or not it includes competitive bidding are generally concerned about appropriate oversight with regard to the financial stability of any participating insurance company.

International comparisons

To illustrate two alternative approaches to the purchase of annuities by older individuals, we next discuss briefly the experiences of Chile and the United Kingdom.

The Chilean experience

Chile has had a national mandatory DC pension system since 1981, and retirees have the choice of taking 'programmed' or phased withdrawals, or buying an annuity. Workers' assets are accumulated in private pension funds, Administradoras de Fondos de Pensiones (AFPs), which also provide the programmed withdrawals; workers may not take lump sums from these accounts. Insurers compete to provide quotes for annuities, and persons whose accounts are less than the amount needed to provide the minimum benefit guarantee cannot purchase annuities. Currently, most Chilean retirees have elected annuity payments (Ruiz and Mitchell, 2012).

To address concerns about the cost and expenses of annuities, a government-sponsored competitive bidding computer-based system named SCOMP was introduced in 2004 to improve competitiveness and transparency, and to better meet participant needs. SCOMP annuity quotations can

be solicited directly by individuals, or an insurance broker can generate these on the retiree's behalf. If an individual purchases an annuity directly via the computer there is no intermediation fee; if a broker is used, an intermediation fee of up to 2.5 percent can be charged (Reyes and Stewart, 2008). Members can request up to three quotes with or without the assistance of brokers or sales agents, from all competing insurers. Upon receipt, the member can accept one of the quotes, request additional offers, or rebid the account.

The Chilean system differs from the institutional platform described above in that it is connected to a mandatory government DC program. By contrast, our institutional platform is linked to a number of pension entities but it is up to plan participants to seek quotes. Once a quote is requested, competitive information is automatically provided for all carriers participating in the program. Moreover, in our institutional platform, there is a fully disclosed one-time transaction fee determined by the service level and program partner, and no further intermediation fees or commissions are paid. Where an advisor is used, the one-time transaction fee is typically the lowest fee available, because the individual then pays the advisor an out-of-pocket fee; the advisor is hired by and represents the individual.

In Chile, although 34 percent of the participants who enter the system do so directly via the Internet, only 12 percent finalize the process without paying a commission. In addition, only a small fraction of the participants use the option to secure a competitive bid (Reyes and Stewart, 2008). Therefore, in Chile and in the Income Solutions® platform, most participants seek and use active guidance and support. With the institutional platform, competitive bidding is automatic, but in Chile it is not, and its use is limited.

The experience in Chile also demonstrates that incentives matter. Where brokers were involved in the process of reviewing annuities, 75 percent of the individuals got the best (highest) payout. Only 43 percent did so when the retirees used the AFP for advice, and only 3 percent when a life insurer was consulted, perhaps because brokers had an incentive to capture customers once contacted. The AFPs participate actively during the accumulation phase but receive no payments for giving advice about payout products (Ruiz and Mitchell, 2012).

Lessons from the United Kingdom

In the past it was possible for retirees to take one-quarter of their accumulated pension wealth as a lump sum, whether from a DB or DC plan; the balance had to be annuitized by age 75. Individuals have had the right to

shop around for an annuity through the Open Market Option (OMO) since 1978, but the majority still used their pension provider to supply their annuity despite the fact that they did not necessarily receive the best annuity rate. Indeed, the difference in income between the best OMO rate and the participant's existing pension provider could be as much as 30 percent, but only about one in three individuals switched to a new provider (Reyes and Stewart, 2008). Starting in 2002, pensioners had to be informed that they had the right to secure annuities from organizations other than their current pension providers, and those with higher incomes were more likely to switch. Twenty-six percent of people with monthly income from £250 to £499 went to the OMO, versus 67 percent of those with monthly incomes over £3800 (Reyes and Stewart, 2008).

The UK government has been working to improve the process with the Pensions Advisory Service, an independent voluntary organization that offers a Pensions Advisory Service (TPAS) online annuity planner. This planner assists individuals in selecting annuities and understanding prices. The planner and various information booklets are part of a larger Money Advice Service, a website organized by the government and financed by a levy on the financial services industry. The planner discusses issues such as single life versus joint, survivor income, inflation protection, and death benefits, thus providing a type of structural guidance (Reyes and Stewart, 2008; Money Advice Service, 2012).

Observations

While Chile and the United Kingdom focus heavily on lifetime income, in the United States program architecture is the main way that plan sponsors drive enrollment, saving, and investment choices. Of course, the United States differs from these other countries by providing significant inflation-adjusted monthly income from the national Social Security system, while the United Kingdom and Chile have mandatory DC plans.

Another factor worth highlighting is the role of competitive bidding. As shown by Hackethal and Inderst (2013), research on the effectiveness of financial advice calls for greater transparency with regard to outcomes, and supports the value of competitive bidding. As we have noted above, when bids are compared over a period of time, who offers the best bid varies over time and by quote scenario. Without a process to facilitate private-sector competition, people tend to remain with their existing providers even if they could substantially improve their monthly income amount and ultimate income sufficiency. Moreover, since many purchasers want multiple quotes before completing a purchase, having the product comparisons available on the Internet is useful. Nevertheless, a lifetime income product

purchase decision is complex, so for most people it requires additional support or guidance.

Another factor is that most of the US annuity buyers (61 percent in our data) on our platform use one-quarter of their financial wealth or less when they annuitize. Thus, buyers appear to be thinking about the purchase as part of a portfolio, implying that the all-or-nothing traditional approach is unlikely to attract many buyers. In Chile, by contrast, people annuitize more because there is a much smaller safety net, compared to the United States. In other words, the commonly accepted belief that annuities are not an attractive way to provide plan distributions is probably flawed, since this conclusion does not recognize the significant deterrents that poor framing, constrained delivery, and lack of guidance often place in the way of annuitization.

Conclusion

Guaranteed lifetime income is an important part of retirement security, but in the United States, Social Security does not provide a sufficient single source of lifetime income for many retirees. When a retirement plan does not provide lifetime income, steps can be taken to boost guaranteed retirement income flows. The institutional purchasing platform described here offers a real-world model that brings together transparency, competition, and guidance in the annuity purchasing process. Structural guidance is a critical component to a system that works well, but it is insufficient: also needed are personal conversations to enhance the chances that people will annuitize a portion of their assets.

Taking advantage of institutional purchasing and structural guidance, the benefits of group pricing and an informed purchasing process can be provided to individuals served by plan sponsors, administrators, advisors, and financial services organizations. Purchasers are more comfortable and more likely to buy when they have active guidance; that is, someone with whom they can discuss the purchase decision and who can help them understand the relevant issues. Competitive pricing can yield higher monthly income amounts.

While annuitization of retirement assets may not suit everyone, it is important to have access to a fair presentation of payout options which include annuities. Further work is needed to better understand the choices made about managing resources in retirement, the barriers to considering guaranteed lifetime income, the influence of key parties, and the policies and programs that help individuals make the best decisions. Moreover, annuities often receive bad press related to their costs, complicated features, and provider risk. Unfortunately, immediate

annuities offering lifetime income are often confused with more complex investment-focused variable annuity products. Another barrier is that financial advice sometimes emanates from sources whose revenue would be reduced if their advisees were to annuitize. In addition, some employers who do seek better financial outcomes for their retirees are still reluctant to get involved in the post-retirement period, due to concerns about fiduciary and legal liability. Further research is needed to determine where conflicts of interest or mixed messages impede actions that are in the best interests of participants with regard to lifetime income.

Appendix: Eight case studies

Case studies and analysis of purchases help explain what happens in the purchase process, based on our experience with the institutional platform.

Buyer A offers an example of a sophisticated purchaser. Buyer A was a female working with a financial advisor, who bought twelve separate annuity contracts, four per year for three consecutive years. Multiple carriers were used, diversifying carrier risk. The transactions were executed by the advisor and the quotes secured by the advisor. These were single life annuities, with inflation indexing in most and some variation in the features. Funds were withdrawn from an IRA and the amount of the premium paid per purchase ($10,000) was the same. Purchasing over time diversifies interest rate risk and allowed the buyer to get accustomed to the annuity. The buyer was at the age of 66 in the first year, and she purchased a total of $575 per month in additional income. Twenty-two competitive price quotes were secured during the process.

Buyer B, a male aged 62 and the joint annuitant a female aged 59, offers another example of a sophisticated purchasing strategy. This purchaser bought from three different insurance carriers at a single point in time, paying a premium of $50,000 per carrier for a purchase of $904 of monthly income. All purchases were from qualified plan funds from a DC plan with the same plan design for each: joint life with 50 percent benefit to the survivor and a ten-year certain benefit. Four quotes were requested within a six-month period from the date of first quote to the purchase date.

Buyer C, a couple, bought five annuity contracts using multiple carriers with a mix of qualified and non-qualified funds; they also bought both single life and joint life policies with a cash refund. Fewer than three weeks transpired from the initial quote to the purchase date, and fifty-one quotes were secured for many different annuity feature combinations.

Buyer D was a retiree aged 85, with a 67-year-old joint annuitant. He bought two contracts about five months apart. His first purchase was

made with the help of a facilitator who requested the quote and executed the purchase. The second was made by the individual. Two different insurance carriers were used. The first purchase was for a joint annuity with 100 percent to the survivor and a term certain, and the second for a single life with term certain. Four quotes were secured and the first purchase was made the same week as the first quote. The premium was $250,000 for the first purchase and $175,000 for the second; the income stream purchased was $1,481 per month in the first purchase and $1,516 in the second.

Buyer E bought a five-year term certain annuity; he was a 61-year-old male using $70,000 of qualified plan funds to purchase $1,200 of monthly income. Nine quotes were obtained and four months passed from the first quote to the purchase. Possible reasons for the purchase of a five-year term certain annuity include a bridge to social security benefits, a desire to defer social security claiming, financing of college expenses, or providing more income to pay off a mortgage.

Buyer F was an 84-year-old female who used $150,000 to purchase $1,653 of monthly lifetime income using non-qualified funds; no refund features were purchased. A facilitator aided in the purchase. Eight quotations were secured, and it took five weeks from the first quotation to the purchase. Purchases by annuitants in their 80s are typically supported by facilitators, often use non-qualified assets, and receive additional scrutiny relative to suitability.

Buyer G was a male aged 65 and female aged 64 who made four purchases using four insurance carriers. A three-week period passed from first quote to final purchase, and thirty quotes were secured involving various combinations of annuity features including a mix of joint life with 100 percent survivor income and single life income; term certain periods of fifteen to twenty years were included. Purchases were made from qualified plan funds, and a facilitator secured the quotes. Total purchase price was more than $500,000 which amounted to less than a third of total liquid net worth. The individual diversified carrier risk by selecting different insurers.

Buyer H was a member of a couple where the wife was much younger: the husband was aged 66 at the time of the first purchase, and the wife was aged 46. The couple made purchases a year apart and bought six contracts, with a premium of $35,000 per contract; they elected a joint and 100 percent survivor benefit with inflation indexing. IRA funds were used, and two weeks elapsed between the time of the first quote and the first purchase. A total of nine quotes were secured and there was an advisor involved.

Endnotes

1. Advisors are individuals providing financial advice to clients. Advice providers are firms that provide advice to employee benefit plan sponsors and administrators, often using an automated platform. Their programs may include call centers and individuals who have conversations with users.
2. Advanced life deferred annuities are annuity contracts that provide for deferral to some advanced age, such as 85, with no death benefit if death occurs earlier. They provide a way to insure the longevity risk starting at the advanced age at moderate cost. Until now, the tax regulations were a barrier to use this type of annuity in tax-deferred retirement funds.
3. A rollover provision allows an amount for a DC plan to be transferred to a DB plan and lifetime income is then provided by the DB plan. In effect, the retiree is buying the annuity from the DB plan.
4. In addition, IRA balances may later be used to purchase individual annuities, but this information is not tracked so we cannot determine how many DC account balances are ultimately converted to annuities (Wray, 2008).
5. The projection could be for any form of structured income in retirement and need not be for lifetime income.
6. Relatively few advisors have taken this route to date; 75 percent of financial planners said they always or frequently advocate systematic withdrawals for income generation, 38 percent always or frequently advocate the time-segmentation approach, and 33 percent of planners always or frequently advocate the essential versus discretionary approach (Guyton, 2011).
7. As an example of a response to a review question from a facilitator, we have the following: 'The buyer has confirmed that he has sufficient funds to cover basic and emergency expenses and that he is not using more than 50 percent of his stated net worth to purchase the annuity.' Examples of review questions that life-only buyers are asked to confirm might be that they understand that there is no benefit beyond their lifetime, and those who buy period certain annuities are asked to confirm that there is no benefit beyond the certain period.
8. Trial annuitization is another example of an alternative model designed to address some of these inherent drawbacks. Advocates of lifetime income alternatives have proposed the concept of trial annuitization, where assets might be annuitized for an initial fixed period; after that, the individual would have a choice to convert to a lifetime annuity or to take some other approach, including receiving a lump sum.
9. Qualified funds are funds in tax-preferred retirement savings accounts such as IRAs and 401(k) plans. The Internal Revenue Code sets limits on how much can be contributed to these funds, and how funds must be withdrawn. The tax treatment of annuities is different when purchased with qualified funds and non-qualified funds.

10. Under US tax law, Section 1035 of the Internal Revenue Code, holders of annuity contracts are allowed to exchange them for other annuity contracts without paying tax at the time of transfer.
11. For an illustrative set of case studies, see the Appendix.

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