RETIREMENT INCOME INSTITUTE
Alliance for Lifetime Income

Who Should Read This Insight:
Financial professionals, annuity manufacturers, and policymakers.

Institute Research Agenda Topic:
New takes on the annuity puzzle.

Insight: THE ANNUITY PUZZLE AND BEQUEST MOTIVES

Definitions of **bolded key terms** are at the end of this article.

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Authors, Titles and Publication Dates of the Articles Addressed in the Insight
Lockwood, Lee. 2012. "Bequest Motives and the Annuity Puzzle." Review of Economic Dynamics 15 (2): 226–43. https://www.sciencedirect.com/science/article/abs/pii/S1094202511000135

IDEAS IN THE INSIGHT YOU CAN PUT INTO ACTION

The author's research findings suggest the following insights and ideas: (1) Individuals without bequest motives (i.e., those who do not wish to leave assets to their heirs) gain more from annuitizing their wealth than those with bequest motives, because an annuity enables an individual to use wealth to finance spending during life, wealth that might otherwise end up as a bequest. (2) Bequest motives could explain the low demand for annuities, particularly within the upper half of the income distribution, since those in the bottom half of the income distribution are already provided a strong annuity benefit through Social Security. Based on the author's findings, we suggest that, to increase annuitization rates among those with a bequest motive, financial advisors focus on annuity death-benefit options.

PRINCIPAL INSIGHTS

This article focuses on the role of bequest motives (i.e., the desire to leave assets to family members, friends, or charitable causes) in explaining the annuity puzzle. The annuity puzzle refers to the divergence between economic theory, which suggests that annuities are better investments for individuals facing longevity risk (i.e., the risk of living longer than expected, and having insufficient funds to finance retirement needs), and the reality that relatively few retirees are opting to receive their retirement benefit in the form of an annuity (i.e., a retirement benefit in the form of a series of payments made at fixed intervals). In this article, Lee Lockwood uses survey data to simulate and estimate the demand for annuities, with the goal of trying to understand the role any desire to leave a bequest has on the demand for annuities. From the simulation, the author derives several insights surrounding factors that help explain demand for annuities, including bequest motives, medical spending risk, and minimum annuity purchase requirements. The insights derived from the author's simulation help explain the low demand for annuities, despite their many benefits.

Those without bequest motives gain more from choosing to annuitize their wealth than do those with bequest motives. For retirees without bequest motives, the author finds that the largest component of the gain from annuitizing their wealth is being able to trade involuntarily leaving a bequest upon their death (because they did not have a chance to spend all of their wealth) for higher spending throughout their remaining lifetime. In contrast, those with bequest motives stand to gain less from annuitizing their wealth, since they can rely on leaving a smaller bequest rather than on purchasing an annuity for consumption smoothing. Consumption smoothing refers to the balance between saving and spending that an individual makes over the course of their life to maintain a consistent, or smooth, level of spending. For example, a person of working age spends some of their income on housing, food, vacation, and so on (i.e., consumption) and saves some of their income for retirement (i.e., savings). At retirement, when income from a job stops, the retiree draws down their savings in order to maintain a level of spending that is similar to and consistent with what they had during their working years.

Lockwood conducted a simulation of the demand for annuities among single retirees in the United States to understand whether any reasonable formulation of the magnitude of bequest motives could help explain the low demand for annuities among American retirees. The author used data on unmarried retirees between the ages of 65 and 69 from a large nationally representative survey in the simulation. Only roughly 3.6% of the individuals included in the sample owned a life annuity. A simple economic model was used to conduct the simulation. Inherent in this model was that the only disadvantage of receiving one's retirement benefit in the form of an annuity is that an annuity is not bequeathable. Additionally, the model included medical spending risk, which many American retirees face, and individuals might be unwilling to give up control of financial assets needed to purchase an annuity if they believe they will need those financial assets to pay for future medical expenses.

The simulation provided the author with several insights into the role of bequest motives in the annuity puzzle. First, the author found that minimum annuity purchase requirements and medical spending risk did not have a significant impact on the aggregate demand for annuities by single retirees, under any of the bequest motives studied. The finding that medical spending risk did not have a significant impact might seem counterintuitive and is in contrast to some other research. The author suggests, however, that the impact of medical spending risk on the demand for annuities is related to the timing of medical spending. For example, those who experience high medical spending early in retirement are less likely to purchase annuities.

Lockwood's key finding is that individuals who have even modest bequest motives reduce the demand for annuities. Because additional saving can be used either for a bequest (in case people die sooner than they expect) or to smooth spending later in life (in case they live longer than they expect), people are less likely to purchase an annuity since the financial assets that they have saved and planned on bequeathing can be used to smooth spending later in life if needed. Overall, the author finds that bequest motives are an important factor that are contributing to the lack of demand for annuities. Based on the author's findings, we suggest that, to increase annuitization rates among those with a bequest motive, financial advisors focus on annuity death-benefit options.

To learn more, visit the Retirement Income Institute at
www.allianceforlifetimeincome.org/retirement-income-institute

KEY TERMS ARE SOURCED FROM THE ALLIANCE FOR LIFETIME INCOME'S ANNUITIES LANGUAGE GLOSSARY AND INVESTOPEDIA

annuitization: *The process of converting an investment into a series of periodic income payments by buying an annuity or beginning an income flow from an annuity.*

annuitize: *When you turn your current account balance into a series of periodic income payments, either for a specific period of time or for your whole life.*

annuity: *A financial product that can offer protected lifetime income and even potentially grow your money.*

annuity puzzle: *The annuity puzzle refers to the fact that few people choose to annuitize even a portion of their accumulated savings even though they have many good and rational reasons to do so.*

death-benefit: *A death benefit is a payout to the beneficiary of a life insurance policy, annuity, or pension when the insured or annuitant dies.*

financial advisor: *A qualified person who can help you understand your options and make financial decisions to work toward your financial goals.*

life annuity: *An annuity that makes payments for the rest of its owner's life.*

longevity risk: *The chance that you will live longer than your income will last.*

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