How Do Retirees Go from Stock to Flow?

Evidence from TIAA-CREF

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Motivation: A Saving/Spending Disconnect

- **Pensions have perhaps two basic goals:**
  1. Facilitate **saving** for retirement
  2. Provide a source of **income** in retirement
- **DC plans (arguably) arose from a focus on giving people more options for "the first" goal.**
  - "Choice" is **the** 401(k) saving buzz-word
  - Implications of "choice" for income are unknown
- **Income adequacy measures often <u>assume</u> an annuitized payout – (i.e., no choice)**
  - Consistent with basic life-cycle model with no precautionary or bequest motive (Yaari '65)

401(k) Plans Emphasize Accumulation

- 401(k) system not yet mature
- Design emphasis is on providing participants with a wide variety of accumulation options
- Few plans have annuity options
- Payout stage an apparent afterthought
- Baby Boomers just a few years away from retirement.
- This needs to be fixed soon!

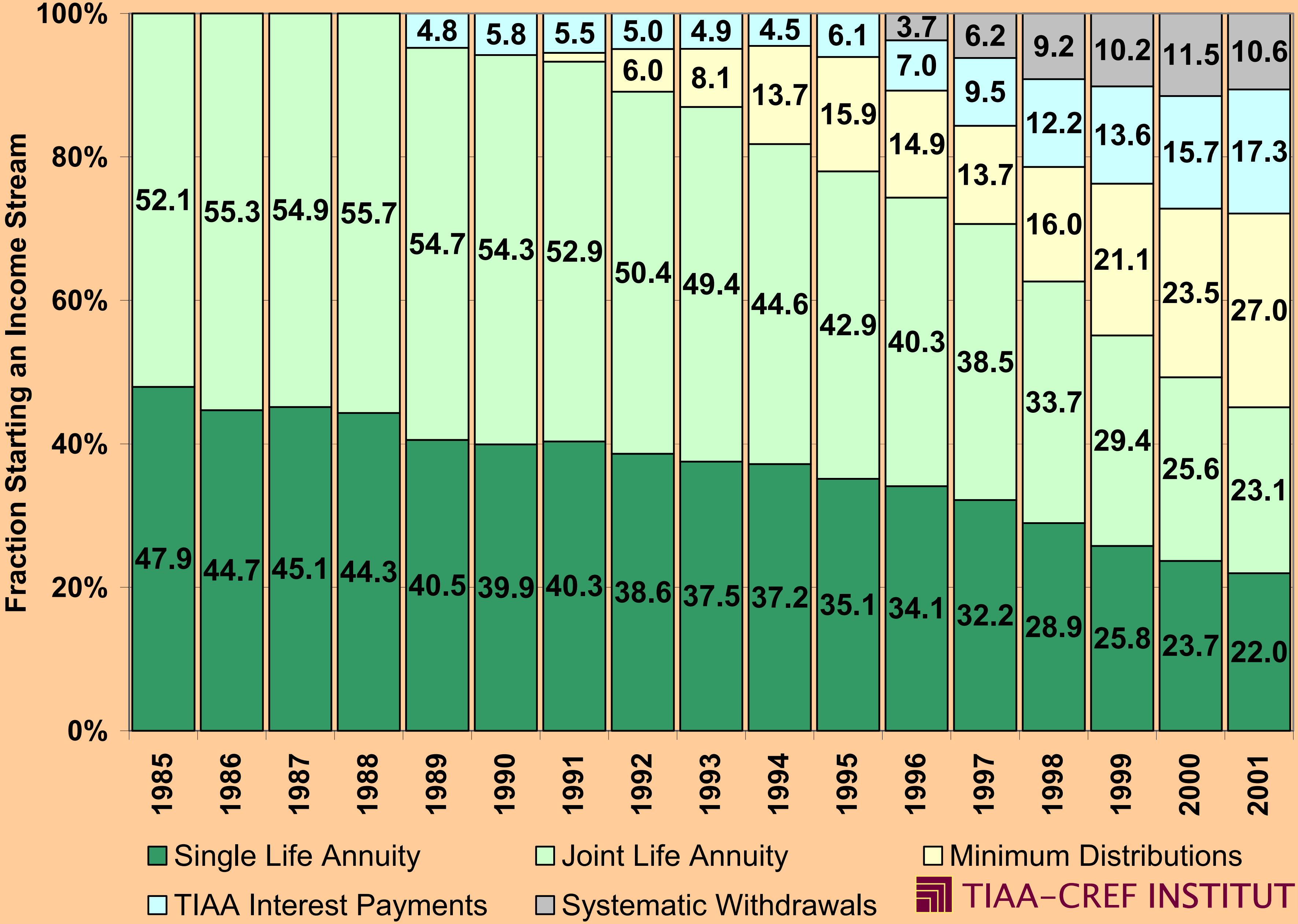
Will Retirees Choose Life Annuities?

- **Financial advisors recommend systematic withdrawal strategies**
  - Exposing clients to longevity risk
  - People may take lump sums
  - People may take default options
  - People may under artificially consume
  - The point: If saving patterns don't match a simple life-cycle model, why would we assume spending patterns would?
  - So what happens when people have annuity options?

Income Options at TIAA-CREF

- **Life Annuities (since 1918)**
  - Single, Joint
  - "Guaranteed Periods" of 10, 15, 20 years
  - **All** TIAA-CREF pension annuities have variable components (TIAA has minimum guarantee)
  - Stock, Bond, Real Estate-based IVAs available
- **Non-Annuity Options:**
  - IPRO (1989)–Interest Payment Retirement Option
  - MDO (1991)–Minimum Distribution Option
  - SWAT (1994)–Systematic Withdrawals and Transfers
  - Period certain annuities

Initial Income Stream Elections 1985-2001



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Why The Decline?

- **Changes in Retirement Patterns**
  - 1994 end of mandatory retirement in higher ed
  - Increasing use of “phased retirement” programs
  - Changes in Social Security taxation
- **Significant precautionary or bequest motives**
- **Other potential explanations**
  - Poor understanding of annuities (TC annuities are complicated)
  - Inertia / “default” behavior on payout side (MDO as a “default”)

Retirement is a Process

- **Estimated retirement rates changed significantly after 1994 for those age 70+:**
  - Very large declines in measured "retirement rate" among those age 69-71.
  - Not among those at lower ages, though…
- **All individuals appear to be delaying income receipt**
  - 5-10% declines in receipt of any form of income (including "lump sums") for 65-year olds since early 1990s
- **More research is needed on the interaction between phased retirement and use of DC retirement balances for income.**

A Cautionary Note

- TIAA-CREF participants look like the general population during the accumulation phase
- Not so during the payout phase
- TIAA-CREF participants are in the labor force longer, and have much better health than the general population
- They also have significantly different mortality than the general population
- For example, the probability that at least one spouse of a 65 year old couple will live to age 90 is 63 %

Election of Income Options is Increasingly Piecemeal

- **It's Not "Now or Never"**
  - Value of waiting to use annuities arises from
    - Irreversibility of annuity purchase
    - Rising mortality/longevity risk with age
- **It's Not "All or Nothing"**
  - In 2001, among those beginning an income stream, 56% did not use the entire balance
  - Up from 34% in 1991.

Bequest Motives:
Use of Annuity Guarantee Periods (2001)

	Annuity type	Guarantee	No Guarantee	Total
Women	Single	48.7%	19.3%	68.0%
	Joint	27.5	4.5	32.0
	Total	76.2	23.8	100.0

	Annuity type	Guarantee	No Guarantee	Total
Men	Single	20.0%	9.5%	29.5%
	Joint	59.2	11.2	70.5
	Total	79.2	20.8	100.0

Public May Have Poor Understanding of Annuities and Longevity/Mortality Risk

- **There is an odd focus on one side of longevity risk**
  - "… You're betting that the total you'll receive over your lifetime will exceed the lump sum." (*Readers' Digest*, Feb 2003, "When an Annuity Pays".)
  - No mention that without the life annuity, one is simply choosing to take the other side of this bet…
- **Immediate annuities are complicated**
  - It may be easier to just start taking withdrawals.
- **Annuities are widely perceived and sold as (expensive) tax-sheltered investments rather than insurance**

Existing Annuities Don’t Address Perceived Deficiencies

- **Precautionary savings motives provide incentive to avoid “tying up” assets in illiquid annuities**
  - Of course, many reasons for precautionary saving can be insured against…
- **Existing annuities are not guaranteed to keep pace with inflation**
  - “Graded” method annuities can mitigate this
  - Variable annuities allow exposure to various asset classes, and expectation of growing payments
- **Product innovation may be needed**

Could Inertia Be an Important Factor?

- **Madrian & Shea (2001) show that default saving and allocation rules can impact savings levels and portfolio choice in a 401(k)**
  - Ameriks & Zeldes show very few elective changes in asset allocation at TIAA-CREF over 1990s, despite dramatic changes in portfolio allocations…
- **When one reaches 70½, regulations generally require a specified level of distribution or tax penalties apply**
  - Is the required amount a "default"?
  - MDO is fastest growing distribution option…

Summary and Conclusions

- **Availability of non-annuity options at TIAA-CREF has been followed by a large decline in the use of life annuities**
  - More data is needed to determine whether people are "waiting" or electing not to use annuities…
- **Process of going from "Stock to Flow" is much more complicated than most imagine**
- **Retiree spending decisions are as important as pre-retiree savings decisions, and need to be better studied**