Why Not?

Insurance You Want to Collect

Ian Ayres and Barry Nalebuff 05.10.10

Most insurance protects you against something bad--a fire or a car accident, for example. But the biggest uninsured risk that most people face is that something quite good will happen: You live a long life. Annuities protect against that outcome. They promise regular payments as long as you (and your spouse) live, so that you won't outlast your retirement savings. If things were accurately named, annuities would be called life insurance (and today's life insurance would be called death insurance).

As compelling as the case is for converting retirement assets into monthly payments, people hesitate when buying annuities, and, when they do buy, often end up with contracts that in varying degrees defeat the purpose of the product.

Buyers get queasy about the possibility that they might die soon after retiring. If that happens, they've spent a large sum and received a very small sum in return. To prevent that risk many customers add a death benefit rider, essentially a lump-sum payment that is made if the annuitant dies young.

These benefit riders are usually a mistake. Opting for one is like betting on both the Colts and the Saints in the Super Bowl. It amounts to deciding that you need to convert assets into lifetime income and then deciding a minute later that you'd like to convert some of the income stream back into a lump sum.

If you live a long time, then you need the extra money and are glad to have purchased an annuity. If you die early, that's an unfortunate outcome, but it also means that you don't need as much money. The death benefit cuts into your monthly payout. On an inflation-adjusted single life annuity, you can collect about 15% more each month if you forgo the death benefit. Giving up the death benefit seems much easier than saving an extra 15% during your working years.

An even bigger problem is that annuity buyers wait too long to start taking bets on when they will die. You should be able to take an even earlier risk of getting nothing back. You'd do this by prefunding an annuity each year of your working life. At age 40, say, you put in $10,000 toward what we might call a "pretirement annuity." It starts payments only if you make it to age 67. At age 41 you'd put in another $10,000. If you don't make it to age 67, all the money is lost.

In return for taking that risk, you will get more money if you do make it. The cumulative chance of dying between 40 and 67 is roughly 20%. Because of the chance you'll get nothing, this prefunding of an annuity at 40 will, if you do make it, boost your return by 25% (over and above the gain from 27 years of compounding). Pretirement would perhaps be a difficult sale for an

insurance agent, but it's not such a foreign concept. Every worker already has a pretirement account called Social Security.

What else do people worry about when they buy an annuity? Some of them fret that they will miss out on stock market gains. Answer: an annuity invested in stocks, with payments linked to market performance. Inflation is another worry, addressed with a payment structure that tracks the Consumer Price Index. That's a commonly used feature and one we strongly endorse. A lot could happen to the cost of living between when you turn 65 and when you turn 85. But you'll have to accept a significantly lower starting payout to get this rider. If you are a male buying an immediate annuity at age 65, the cola costs you a fourth of the payout.

An upfront payment of $500,000 gets a 65-year-old man about $2,400 in inflation-adjusted monthly payments. That figure seems low, but it reflects the fact that people are living longer and there's a long-run risk of inflation. What that means is that to replace half your income, you'll need savings equal to nine times your income, which seems out of reach for most people. That's all the more reason to forgo death benefits and to prefund the annuity.

The pretirement annuities we are proposing are really no different from a private version of Social Security. With Social Security all of those payments you make are lost if you (and your spouse) don't make it to retirement age. On the other hand, if you do make it then you have an inflation-adjusted annuity for as long as you live. The big difference in our approach is that, unlike Social Security, our proposed annuity is fully funded.

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