Why the Wealthy Should Buy SPIAs

By Editor Test *Tue, Aug 17, 2010*

A recent study by a doctoral candidate at the University of Virginia examines all of the reasons why people don't buy income annuities--and reveals two hidden reasons why they should.

Factors	Impact on low quintiles	Impact on high quintiles	Overall effect
Preannuitized wealth	Big (negative)	Big (negative)	Big (negative)
Medical expenses	Big (negative)	Big (positive)	Small (positive)
Adverse selection	Big (negative)	Big (positive)	Small (negative)
Bequest	None	Big (negative)	Small (negative)
Consumption floor	Big (negative)	Small (negative)	Big (negative)
Illiquid housing	Small (negative)	Small (negative)	Small (negative)
Minimum premium	Big (negative)	Big (negative)	Big (negative)

In the 1983 novel, "Eleni," a man asks his elderly grandfather, who had been a local gallant during his youth, to explain the secret to his success with women. The grandfather replies: "By knowing who wanted me."

The same wisdom might may apply to selling income annuities. Success may depend more on the receptivity of the buyer than the determination of the seller.

A doctoral candidate at the University of Virginia has now added to the world's store of knowledge about marketing immediate income annuities by publishing a highly detailed paper that explains who is or isn't likely to be receptive to one, and why.

The findings that researcher Svetlana Pashchenko describes in her paper, "Accounting for Non-Annuitization," won't shock you. She determined that most people don't buy income annuities because they already have "pre-annuitized wealth" in the form of Social Security benefits, private pensions or government transfers like Medicaid or welfare.

No surprise there. Social Security "crowds out" private annuities. But Pashchenko broke some new ground in assessing seven obstacles to income annuity purchases and assessing their relative weight for people with different income levels.

Only the relatively wealthy can afford an income annuity, she found. And there are two potential reasons why they would buy one. (Marketers may want to jot these down.)

First, those who worry about future medical expenses might buy an annuity to fund them. "Uncertain medical expenses increase demand for annuities because health expenditures are increasing with age: the state of being old and alive coincides with the state of being old and having to pay high medical costs. Thus, insurance against longevity risk and insurance against medical costs uncertainty compliment each other," the paper said.

Second, those in good health, as a group, may find that adverse selection actually makes annuities cheap for them.

It's well-known that people who buy annuities tend to live longer than those who don't, and that drives up the cost for the average person. A middle-income person in bad health, for instance, will tend to overpay for an income annuity by as much as 35%, Pashchenko estimated. Even a healthy poor person tends to pay 25% extra for an income annuity, because low incomes are associated with shorter lifespans, regardless of current health status.

But healthy people in the fourth and fifth (the two highest) wealth quintiles pay 5.3% and 13.1% *less*, respectively, than their actual life expectancies would call for, Pashchenko wrote. Apparently, enough members of the general population buy income annuities to make them a bargain for those with the lowest mortality risk—the healthy rich.

"Since mortality is negatively correlated with permanent income, this means that in the pooling equilibrium, higher income quintiles will face better prices and thus get an implicit subsidy from low income quintiles," the paper said. Is that fair? Probably not. But it appears to be true.

Pashchenko also found that income annuities can increase the consumption levels of those wealthier owners by almost nine percent. "For a retiree in good health and in the highest income quintile the loss of opportunity to invest in annuities is equivalent to 8.9% of consumption," she wrote. "For people in good health and in high income quintiles the opportunity to have access to the annuity market is very valuable."

Pashchenko presented her paper August 6 at the 12th annual conference of the Retirement Research Consortium in Washington, D.C. In concluding her presentation, she conceded that she had not entirely solved the "annuity puzzle." Despite all the headwinds that she identified and quantified, she calculated that income annuity sales should be about three times higher than they currently are.

The table below, from Pashchenko's paper, shows seven factors associated with demand for income annuities, along with their impact on demand among lower income groups and higher income groups. Note that "Medical expenses" and "Adverse selection" are the only positive drivers of demand, and only among the upper income quintiles.

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Source: Pashchenko, Svetlana, "Accounting for Non-Annuitization." Federal Reserve Bank of Chicago, WP 2010-03.