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HOUSEHOLD DEMAND FOR VARIABLE ANNUITIES

BY JEFFREY R. BROWN AND JAMES M. POTERBA

The shift from defined benefit to self-directed defined contribution plans, the possibility of reforming Social Security so that it includes personal accounts, and the growth in IRAs are examples of a broad shift toward greater self-reliance in the provision of retirement income in the United States. In policy and academic discussions of individual retirement security in this new environment, two issues are particularly prominent. First, much attention has been paid to the role of equity markets, and the extent to which workers utilize equities as part of their retirement portfolios. There has been a steady rise in the extent of equity market participation over the past two decades, largely as a result of the growth of mutual funds and the expansion of self-directed retirement accounts. The second issue is the decline in life annuitization in retirement, arising primarily from the shift away from automatically annuitized DB plans and towards DC plans, such as 401(k)s, few of which even offer annuities as a payout option.

Despite the significance of both equity ownership and annuitization, very little research has focused on the rapid growth during the 1990s of a class of products known as variable annuities, which in principle combine equity ownership and an option to annuitize. While variable annuities were first introduced by insurance companies in the mid-1950s to compete with mutual funds, the market remained quite small for several decades. In the early 1990s, however, the market began to grow rapidly. According to the American Council of Life Insurers, gross sales of individual (non-group) variable annuity considerations rose from \$3.5 billion in 1990 to nearly \$63 billion in 1999.

Individuals may demand variable annuities for at least three, not necessarily exclusive, reasons. The first is to accumulate wealth at favorable after-tax rates of return. Interest, dividends, and capital gains that accrue on assets held in variable annuity accounts are not taxed until the policyholder receives variable annuity payouts. This provides policyholders with the tax benefits of “inside build up,” just as in the case of Individual Retirement Accounts and 401(k) plans. A second potential attraction of variable annuities is that they provide various forms of insurance, such as the common provision that if the policyholder dies before retirement, heirs receive at least the nominal value of the policy contributions. The third motivation for holding variable annuities is the option to convert to a life annuity and thus provide annuitized income in retirement, with the payouts indexed to the performance of a diversified investment portfolio.

This paper describes the tax treatment of variable annuities and presents summary information on the ownership patterns for variable annuities. It also explores the relative importance of these three distinct motives for household purchase of variable annuities. Using household data from the 1998 and 2001 waves of the Survey of Consumer Finances, we examine ownership patterns and test for the importance of tax and insurance considerations in variable annuity demand. We find that variable annuity ownership is highly concentrated among high income and high net wealth sub-groups of the population, although the concentration is lower than for several other categories of financial assets. We find mixed support for the role of tax considerations in generating variable annuity demand.

We also document that household risk aversion is not positively correlated with the demand for variable annuities, casting some doubt on the importance of the insurance motivation for purchase. We also discuss the limited extent to which variable annuity products appear to be converted to life contingent payout streams at retirement. Finally, we outline a set of research issues that focus on household annuity purchases.

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CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

Fulton Hall 550, 140 Commonwealth Avenue, Chestnut Hill, MA 02467-3808
phone 617.552.1762 fax 617.552.1750 crr@bc.edu www.bc.edu/crr