Deferred Income Annuities: The Case for Commutation

Deferred Income Annuities

While life expectancy and the time individuals spend in retirement continue to increase, individuals' ability to count on guaranteed lifetime income from sources such as pension plans and Social Security continues to decrease. Products that provide guaranteed lifetime income are one of the most effective ways to plan for a secure retirement. A deferred income annuity (DIA) is one such product. A DIA is a very similar product to a single premium immediate annuity (SPIA) but is designed to delay the commencement of annuity payments. While DIAs are sometimes used as end-of-life longevity insurance, the vast majority of DIAs are purchased by individuals at or near retirement with relatively short deferral periods (2 to 10 years). Purchasing a DIA permits the owner to receive significantly more guaranteed income than SPIAs and other types of deferred annuities offer.

DIAs provide many of the same features available on SPIAs. However, unlike their immediate counterparts, DIAs do not include an option to access all or a portion of the remaining guaranteed payments under the contract. Even though very few consumers elect to use these SPIA liquidity features, distributors often cite them as important to overcoming consumer reluctance to commit funds to income annuity products.

Consumer Acceptance

Given the unique characteristics of a DIA, the product can be marketed to a broad group of consumers including Baby Boomers and pre-retirees. The DIA allows them to create their own ‘personal’ pension plan. DIA sales are gaining traction with sales growing from $200 million in 2011 to $2.7 billion in 2015.

However, DIA sales make up only 1% of the overall annuity industry and sales have paled in comparison to other annuity products that offer lifetime income despite the fact that DIAs typically offer the highest guaranteed income amount when compared to other deferred annuities. Many industry experts and financial advisors attribute these disparities in sales to the lack of liquidity with DIAs, a feature found on SPIAs and other deferred annuities. Many consumers are hesitant to purchase a DIA as they fear the possibility of their economic circumstances changing dramatically after purchase, and not having the ability to access their funds other than as income payments.

Commutation: A Needed Feature To Enhance Appeal

Allowing commutation on a DIA product after income begins will enhance the appeal of the product and overcome consumer reluctance to commit funds to these contracts. The commutation feature would allow the policy owner to withdraw up to 100% (subject to applicable tax rules) of the discounted value of their remaining guaranteed payments at any time. Only payout options that provide for a guaranteed period would be eligible. These options include Period Certain, Cash Refund, and Installment Refund. While, similar to SPIAs, a commutation feature should not be actively marketed and the suitability process should keep the need to access a commutation feature to a minimum, allowing for it would put consumers at ease and encourage the purchase of a needed and valuable product that will provide them with a guaranteed future income for life at a price that many may not otherwise be able to afford.