What Makes Annuitization More Appealing?

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Introduction

Many households resist annuitization. In U.S. defined benefit (DB) pensions plans that offer a lump-sum option, about half of households take their entire retirement benefit as a lump sum, even though the annuity is the default option and opting out requires time-consuming paperwork (Mottola and Utkus, 2007; Benartzi, Previtero, and Thaler, 2011; Previtero, 2012). In defined contribution (DC) savings plans, only 10% of participants who leave their job after age 65 annuitize their assets (Johnson, Burman, and Kobes, 2004). This resistance to annuitization is referred to as the “annuitization puzzle” (Modigliani, 1986), since the benefit of buying insurance against outliving one’s savings should create strong demand for annuities (Yaari, 1965).

In this paper, we identify some of the factors that influence consumer attitudes toward annuitization, focusing on product design and how choices are presented. To study these issues, we fielded two large surveys in which we asked individuals aged 50 to 70 to make hypothetical annuitization choices. We examine 1) what factors people say are important to their annuitization choices, 2) how offering “partial annuitization,” rather than an all-or-nothing choice, influences outcomes, 3) individual preferences on an annuity that increases with inflation, 4) whether altering the presentation used to describe the different options influences annuitization preferences, and 5) whether there is demand for an annuity product that makes an extra “bonus” payment during one month of the year that is funded by slightly lower payments in the remaining months.

We found that allowing individuals to annuitize a fraction of their wealth increased annuitization relative to when annuitization was presented as an “all or nothing” decision. Highlighting the effects of inflation increased the demand for inflation protection. The treatment arms that focused on flexibility and control, and investment risk significantly reduced annuitization. A majority of respondents preferred to receive an extra “bonus” payment during one month of the year that was funded by slightly lower payments in the remaining months. Concerns about later-life income, spending flexibility, and counterparty risk were the most important self-reported motives that influenced the annuitization decision, whereas the desire to leave a bequest had little influence on that decision.
Survey Design

Survey 1 asked participants to make choices under the following hypothetical scenario: “Just before you retire at age 65, you are working for a company that will give you pension payments every month for the rest of your life after you retire. This income is guaranteed, but the payments will stop when you die. You will also receive Social Security benefits every month for the rest of your life after you retire.” This scenario is similar to that of a traditional DB pension plan.

Respondents were told to assume that inflation would be 2% for the rest of their lives. Participants made choices about whether to purchase an annuity that would match inflation, whether to receive a once a year “bonus” payment, and how much of their annuity to cash out and receive as a lump sum. In each case, the annuity was valued at $330,000. We included no fees or markups for costs. In order to avoid having responses be influenced by any negative association participants might have with existing annuities, nowhere in the survey did we use the word “annuity” or “annuitization.”

After answering all of the annuity choice questions, participants were asked to rate on a six-point Likert scale (0 for not important, 5 for very important) the importance of eleven potential reasons for their cash-out choices. Participants were also asked about their life expectancy relative to the average person of their age and a set of demographic questions.

In Survey 2, participants were also asked to make annuitization choices based on a hypothetical retirement scenario. This scenario, which is different than the one presented in Survey 1, was described in the first page of the survey:

“Suppose that you are 65 years old. You are about to retire and have accumulated $500,000 in the pension plan at your current employer. Your employer wants to know whether you prefer to receive this balance as a lump sum payment right now (in other words, a single $500,000 payment) or as a stream of fixed payments over your lifetime, which your employer calls the guaranteed lifetime income option. This stream of fixed payments is based on current market interest rates. The fixed payments won’t change in the future even if market interest rates do change.”

As in Survey 1, nowhere in Survey 2 is the word “annuity” or “annuitization” used. The annuity option was described throughout the survey as a “guaranteed lifetime income option.”
In Survey 2 we based our annuity payouts on actual price quotes from Western National Life Insurance as of March 1, 2012 for a $500,000 annuity. The final monthly payout offered for somebody annuitizing 100% of his or her balances was $2,981 per month for single survey participants and $2,616 for married participants.

Participants were randomly assigned to one of eight different treatment arms, Minimal Framing Baseline, All or Nothing, Good Deal, Total Payments, Investment Framing, Flexibility and Control, Longevity Insurance, and Mortality Credits. In all of the treatments except for All or Nothing, participants could choose to take 0%, 25%, 50%, 75%, or 100% of their $500,000 balance as a lump sum.

After making an annuitization choice, participants were shown a graph of the likelihood that a person aged 65 today would live to at least age 70, 75, 80, 85, 90, 95, and 100. They were asked to again elect how to receive their pension payment, with the qualification that it was fine to give the same answer as the previous question. The purpose of this second question was to see whether unrealistic life expectations were affecting the annuitization choice.

Survey 2 participants were asked the same exit questions as Survey 1 participations.

Results

A. Obstacles to and motivations for annuitization

We analyze the average importance individuals report placing on various factors when making their lump sum versus annuitization choices. Worries about inflation (average rating of 3.0 to 3.3), the desire to invest the money on one’s own (average rating of 3.0 to 3.1), and the desire to prevent overspending (average rating of 2.7 to 2.9) are intermediate-level concerns. In contrast, two other motives that are commonly discussed in the annuities literature are reported to have little absolute importance by participants. The desire to give money to children or others has an average rating of 2.0 to 2.4, and worries about dying early receive an average rating of 2.3.

B. Partial annuitization

We compare the first annuitization choice in Survey 2 (before respondents saw the mortality chart) under the All or Nothing treatment to the same choice in Survey 2 under the Minimal Framing baseline. We find that a majority of individuals (59%) choose partial annuitization when given the opportunity to do so. These partial annuitants represent shifts from both the full annuitization and full lump-sum outcomes under the All or Nothing treatment. The
fraction of individuals who fully annuitize falls from 50% to 21%, and the fraction of individuals who choose a full lump sum similarly falls from 50% to 20%. Correspondingly, allowing for partial annuitization increases the fraction of people choosing a positive amount of annuitization from 50% to 80%. Moreover, allowing partial annuitization raises the average percent of pension wealth annuitized from 50% to 57%. These last two differences are significant at the 1% level and do not qualitatively change if we additionally control for demographic variables. Our findings suggest that expanding the use of partial annuitization in DB settings where total cashouts are already allowed might lead to higher annuitization rates.

C. Inflation

We can use our survey results to examine subjects’ preferences for an inflation adjustment. Among respondents of Survey 1, 72% prefer the annuity with an inflation adjustment, while 28% prefer an annuity with no inflation adjustment. The result suggests that a short description of inflation’s impact when a consumer is making a decision about an annuity could substantially raise the demand for inflation protection.

D. Presentation of Choices

We examine the impact of the presentation treatment arms in Survey 2 on whether respondents chose to annuitize any balances before seeing the mortality graph, and the fraction of those balances annuitized. The key explanatory variables in the regressions are six presentation treatment dummies (the Minimal Framing treatment is the excluded category); the regressions also include a set of demographic controls. The only demographic variable that is significantly associated with the level of annuitization is marital status; married participants annuitize 4.1 percentage points more of their balances than those who are single (significant at the 1% level). Both the Flexibility and Control and Investment Framing treatments decrease the level of annuitization relative to the Minimal Framing baseline at the 1% significance level; those in the Flexibility and Control treatment have an 8.7 percentage point lower level of annuitization, while those in the Investment Framing treatment have a 6.0 percentage point lower level of annuitization. The remaining four framing treatments have coefficients that are closer to zero and not statistically significant.

As a final framing experiment, we asked Survey 2 participants to make their annuitization choice again after seeing a graph of the probabilities of surviving to different ages, conditional

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1 The All or Nothing treatment recipients are excluded from the regression sample.
on living to age 65. The average annuitization rate in every experimental condition is lower after seeing the mortality graph; the percent of balances annuitized across all conditions drops from 55.4% to 52.2%, a difference that is significant at the 1% level. The systematic drop could indicate that our respondents were on average over-optimistic about their expected longevity, and the mortality chart mitigated some of this bias, reducing annuity demand.

E. Annuities with “bonuses”

Survey participants cited the desire for “flexibility in the timing of my spending” as one of the most important factors in their annuitization decision. Our prediction that this consideration would be important motivated exploring the demand for an annuity that offered a higher “bonus” payment in one month of each year, funded by lower payments in the remaining months. We find that 60% of Survey 1 respondents preferred a Match-Inflation Income with Bonuses annuity over a Match-Inflation Income annuity without a bonus. Among those choosing the bonus, 58% wanted the bonus to be paid during the winter holiday season—November, December, and January.

Conclusion

This paper’s results have several implications for annuity product design and presentation. To increase annuity demand, annuity providers could design products that give beneficiaries more flexibility and control. Our bonus annuity is an example of personalization that increases flexibility and control without compromising longevity insurance. Other forms of personalization and flexibility could also be adopted, such as limited penalty-free early withdrawals and even asset allocation flexibility (adopting some features of the variable annuity market). Of course, there is a tradeoff between greater flexibility/control and greater complexity. Too much flexibility may drive some consumers away from annuities (cf. Ivengar and Kamenica, 2010). Finding the sweet spot in product design space is a significant challenge but one that is worth taking on because of the scope for large potential welfare benefits.

Presentation changes may also increase the appeal of annuities, especially presentations that highlight the availability of partial annuitization. Our results imply that most consumers prefer partial annuitization of their retirement nest egg over either 0% or 100% annuitization. We find that the availability of partial annuitization also raises the average fraction of wealth that ends up annuitized. Finally, participants report that fears of counterparty risk play a large role in
their annuitization choice. Policy makers could increase annuity demand by adopting regulations that reduce this fear.

References


