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What makes annuitization more appealing?☆

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ABSTRACT

We conduct and analyze two large surveys of hypothetical annuitization choices. We find that allowing individuals to annuitize a fraction of their wealth increases annuitization relative to a situation where annuitization is an “all or nothing” decision. Very few respondents choose declining real payout streams over flat or increasing real payout streams of equivalent expected present value. Highlighting the effects of inflation increases demand for cost of living adjustments. Frames that highlight flexibility, control, and investment significantly reduce annuitization. A majority of respondents prefer to receive an extra “bonus” payment during one month of the year that is funded by slightly lower payments in the remaining months. Concerns about later-life income, spending flexibility, and counterparty risk are the most important self-reported motives that influence the annuitization decision.

1. Introduction

Many households resist annuitization. In U.S. defined benefit (DB) pension plans that offer a lump-sum option, between 50% and 75% of eligible DB benefits are taken as a lump sum, even though the annuity is the default option and opting out requires time-consuming paperwork (Mottola and Utkus, 2007; Benartzi et al., 2011; Previtero, 2012; Banerjee, 2013). In defined contribution (DC) savings plans, only 10% of participants who leave their job after age 65 annuitize their assets (Johnson et al., 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; Davidoff et al., 2005).

Researchers have explored a variety of rational motives that could explain the low demand for annuities, such as adverse selection (Mitchell et al., 1999; Finkelstein and Poterba, 2004), bequest motives (Friedman and Warshawksy, 1990; Brown, 2001; Inkmann et al., 2011; Ameriks et al., 2011; Lockwood, 2012), uncertain healthcare expenses (Pang and Warshawsky, 2010; Ameriks et al., 2011; Poterba et al., 2011), annuity prices (Warner and Pleeter, 2001; Fitzpatrick, 2012), means-tested government benefits (Pashchenko, 2010; Bütler et al., 2011), and the annuity embedded in Social Security and defined-benefit pension plans (Bernheim, 1991; Dushi and Webb, 2004; Besheares et al., 2011).

In this paper, we take no stand on how much of the annuitization puzzle remains after accounting for these rational motives. We instead focus on the elasticity of annuity demand with respect to annuity product design and choice architecture.[1] To study these issues, we fielded two large surveys in which we elicited hypothetical annuitization choices from individuals aged 50 to 75. We examine 1) what factors people say are important to their annuitization choices, 2) how offering “partial annuitization,” rather than an all-or-nothing

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[1] Other authors have also studied the role of behavioral factors in annuity choice such as recent stock market returns (Chalmers and Reuter, 2012; Previtero, 2012) and framing (Brown, 2008; Brown et al., 2008, 2012; Agnew et al., 2008).

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choice, influences outcomes, 3) individual preferences over the intertemporal slope of annuity payouts, 4) whether altering the framing[2] used to describe options influences annuitization choices, 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.

The use of surveys such as these has advantages and disadvantages. On the positive side, we can ask questions that directly measure specific preferences, including preferences for products not available on the market. We can also examine choices in economic environments that differ from the current one. On the negative side, the choices people make do not influence their actual life outcomes, so the results may not correspond to the choices people would make in real-life settings. Surveys like ours provide a starting point for designing field experiments with larger stakes.[3]

Five findings emerge from our surveys. First, there are three considerations that respondents report being most important for their decision about whether or not to annuitize: a desire to "make sure I have enough income later in life," a desire for "flexibility in the timing of my spending," and being "worried about [the] company not being able to pay me in the future." Current regulations ban insurance companies from mentioning back-stop state funds in their marketing of annuity products. While such bans may reduce moral hazard problems by encouraging consumers to be selective, they may also have the perverse effect of decreasing annuity demand. We provide new evidence that this latter effect is important.

Second, we find that a substantial fraction of people choose partial annuitization when it is offered, and that offering partial annuitization rather than an "all-or-nothing" annuitization choice increases both the percentage of people choosing any annuitization and the average percentage of pension balances that are annuitized. Many DB pension plans offer individuals the choice between taking a lump sum and an annuity.[4] The U.S. Treasury Department recently proposed a new regulation to make it easier for DB plans to offer a combination of an annuity and a lump sum (Federal Register, 2012). Our findings suggest that this proposal will increase annuitization in plans that already offer a lump sum withdrawal option.

Third, we find that holding the present value of expected payments fixed, very few respondents choose declining real income paths. Our respondents prefer flat or rising real income paths. This result underscores how puzzling the dearth of inflation-indexed annuities in the marketplace is. This result also contrasts with the empirical fact that holding household composition fixed, real consumption declines by about 2% per year during retirement (Hurd and Rohwedder, 2011). We also find that making salient the effects of inflation on real payout values increases the demand for cost of living adjustments (COLAs).

Fourth, we find that two framing changes significantly reduce demand for annuitization relative to a neutral frame: one that focuses on flexibility and control, and a second that focuses on investment attributes. Four other framing changes do not have a significant effect on annuitization: explaining that the annuity being offered is a better deal than what could be purchased on the open market, presenting the total expected undiscounted lifetime payments from the annuity, explaining that the annuity provides insurance against outliving one's savings, and explaining that the annuity transfers money from states where one is dead and the value of money is low to states where one is alive and the value of money is high.

Finally, we find that 60% of our subjects prefer a product that pays an annual bonus in a month of their choosing over a product with a traditional uniform monthly payout. Annual bonuses expand annuitants' control over their high-frequency payout streams without jeopardizing the low-frequency withdrawal restrictions that make longevity insurance possible. The preference for such a product is consistent with subjects' responses that wanting "flexibility in the timing of my spending" is an important factor in their annuitization decision. Allowing more customization of payout streams may increase annuity demand. Other customization schemes are easy to imagine, such as multiple intra-year bonuses or age-contingent payout patterns.

The remainder of the paper is structured as follows. In Section 2, we describe our two surveys. In Section 3, we present summary statistics on our sample, and in Section 4, we present our empirical results. Section 5 concludes by discussing the implications of our findings for the design of pensions and annuity products.

2. Survey design

We designed two surveys and retained the online survey firm Toluna to administer them to 1000 (Survey 1) and 4130 (Survey 2) U.S. residents aged 50–75 in August 2011 and June 2012, respectively.[5] U.S. macroeconomic conditions were similar in both periods, characterized by a tepid recovery from a deep recession. The seasonally adjusted trailing one-year GDP growth rate was 1.6% in the third quarter of 2011 and 2.1% in the second quarter of 2012. The unemployment rate was 9.0% in August 2011 and 8.2% in June 2012. The trailing one-year S&P 500 total return was higher at the beginning of August 2011 than at the beginning of June 2012 (19.7% versus −0.4%).[6] The median times taken to complete the surveys were 13 min (Survey 1) and 8 min (Survey 2). Participants in both surveys made hypothetical choices about pension income in retirement. They then ranked the importance of different reasons for their choices and answered a set of demographic questions during the same online session. The full surveys are available in the online appendix.

2.1. Survey 1

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." Note that this scenario is like that of a traditional DB pension plan.

Because one of the main issues we wished to explore in this survey was preferences over real annuity payment growth rates, we told respondents to assume that inflation would be 2% for the rest of their lives. We described inflation as follows: "With inflation, prices rise, so you get less for your money than you used to. For example, suppose a basket of groceries costs you $100 today. A year later, the same groceries will cost you $102. The price of the groceries has

[2] We abuse the "framing" terminology slightly by using it to describe some treatments that not only present the choice in a different way, but also provide additional information.

[3] Arguably, survey responses from those who are more likely to be in a position to purchase annuities would correspond more closely to real-life choices. All of our results on framing treatment effects and demand for alternative annuity products are similar when restricting the sample to those who have net worth above the sample median.

[4] A 2011 Aon Hewitt survey of 227 DB plan sponsors found that over 40% offered a lump sum option, and over 20% more responded that they were "very likely to implement" or "somewhat likely to implement" a lump sum payment option in the future (Aon Hewitt, 2011). It is thought that many employees perceive the annuitization versus lump sum choice as being an "all-or-nothing" choice (http://www.treasury.gov/press-center/press-releases/Documents/020212%20Retirement%20Security%20Factsheet.pdf).

[5] Participants were part of a large panel maintained by Toluna who are paid for their participation in each survey. We ran two separate surveys because our research program evolved over time.

[6] Based on the evidence of Previtero (2012), it is possible that our respondents' baseline desire to annuitize was lower in Survey 1 than in Survey 2 because of the higher prior stock market return in August 2011.