

WHAT MAKES ANNUITIZATION MORE APPEALING?

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The annuity puzzle

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- Empirical behavior inconsistent with standard models of annuity choice
- When given a choice, most individuals prefer cash in hand to an annuity payout
 - ▣ DB plans
 - Plans increasing give retirees a lump sum option
 - Retirees often take the lump sum option when it is offered
 - ▣ DC plans
 - Few plans offer annuitization options
 - Take-up low in the plans that do
 - ▣ Few individuals purchase annuities outside of their retirement savings plan

Our broad research agenda

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- Why don't people seem to want/choose/value annuities?
 - ▣ Economic barriers
 - ▣ Psychological barriers
 - ▣ Biases in choice architecture (DB and DC)
- What can be done to make annuities more appealing?
 - ▣ Product design
 - ▣ Choice architecture
- Current paper: conduct and analyze an internet survey on hypothetical choices
- Future work: data on actual choices in DB and DC settings

Two internet surveys (S1 and S2) on annuity preferences

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- Two internet surveys
 - ▣ U.S. residents, aged ~ 50-75
 - ▣ Sample size: 1000 (S1) and 4000 (S2)
 - ▣ Time periods: August 2011 (S1), June 2012 (S2)
- Respondents presented with hypothetical situations and choices about retirement income options

Advantages and disadvantages of using an internet survey on hypothetical choices

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□ Advantages

- Can examine taste for products that are not currently available in the market
- Can ask people about economic environments different from the current one

□ Disadvantages

- Life outcomes do not actually depend on choices
- Survey responses may consequently not correspond to what people would choose in real life

What the participants were told (Survey 1)

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- 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.
- The company lets you choose between retirement income options. The total cost to the company of providing these lifetime payments to you is expected to be the same under each option.

What the participants were told (Survey 2)

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- 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.

Survey questions and treatments

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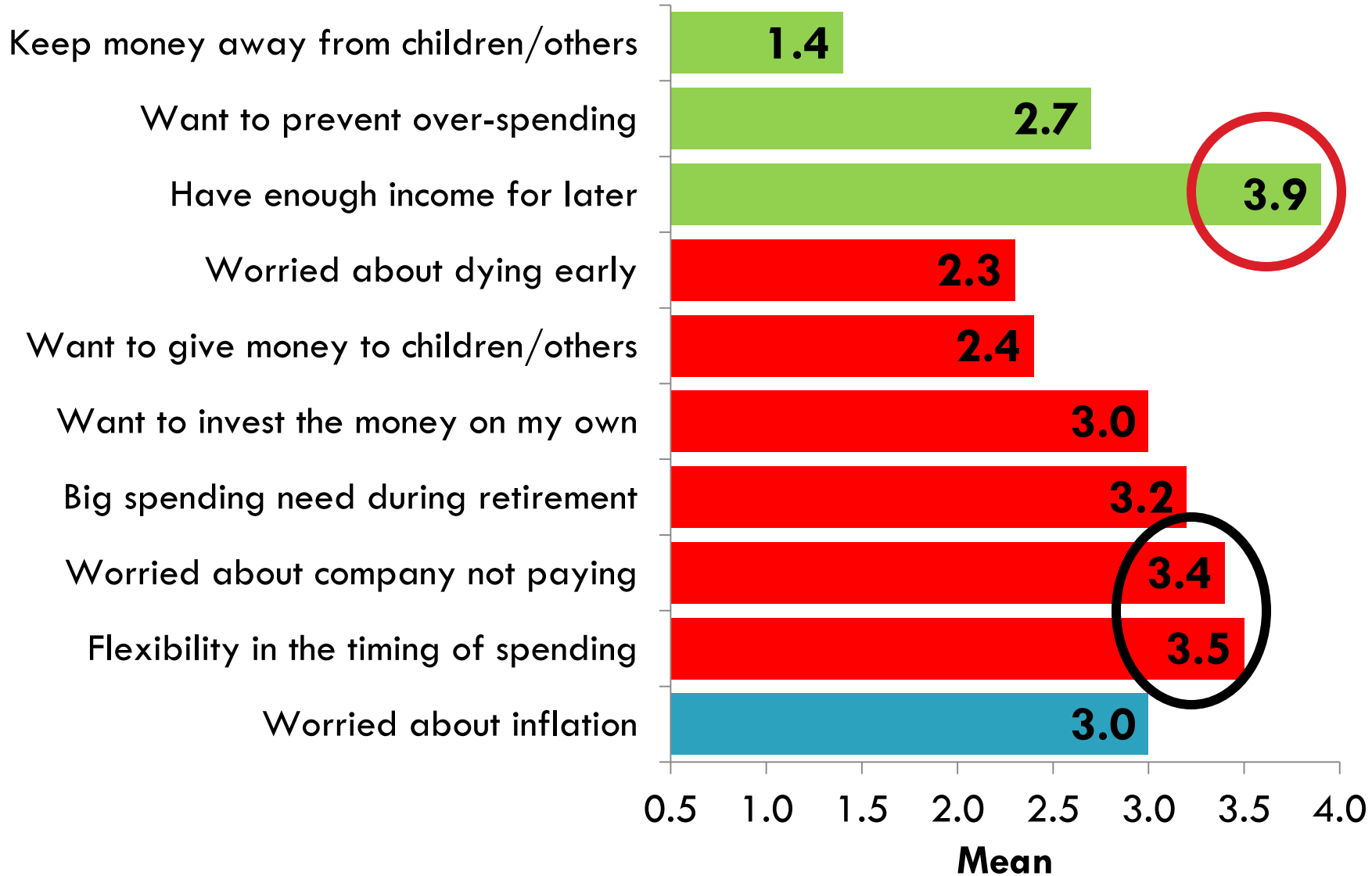
□ Questions

- ▣ Preferences over lump sum payment vs. monthly income stream
- ▣ Preferences over payout slopes (COLAs)
- ▣ Reasons behind choices
- ▣ Demographics

□ Treatments

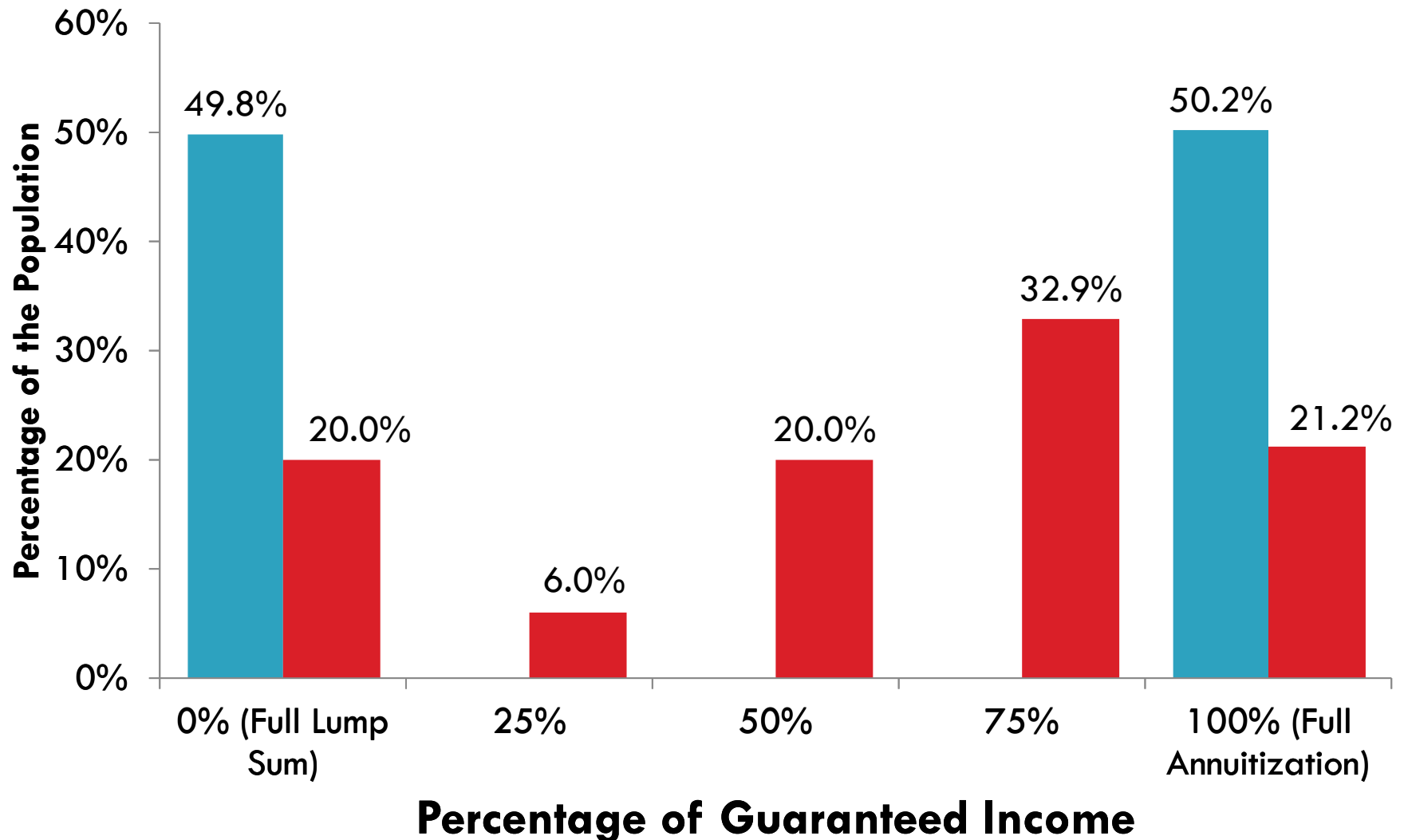
- ▣ “All or nothing” vs. partial annuitization (S2)
- ▣ Framing: changing the language used to describe the annuity (S2)
- ▣ Annual bonuses

Average Importance Rating (1-5 Scale)



“All or nothing” vs. Partial annuitization

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“All or nothing” vs. partial annuitization

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	All or Nothing	Partial Annuitization	P-value
Subjects choosing partial annuitization	---	58.8%	---

- Significant demand for partial annuitization
- Allowing for partial annuitization
 - ▣ Increases the fraction of people annuitizing
 - ▣ Increases the fraction of wealth annuitized

Cost of Living Adjustments (COLA)

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- Two features of typical COLA
 - ▣ Increases the slope of expected income stream
 - ▣ Hedges inflation risk
- These two features can be separated
 - ▣ First survey focuses on desired slope of income stream
 - ▣ Second survey focuses on both together (typical COLA)

Respondents asked for preferences over payout slopes (S1)

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- Offered choices between different (real) slopes

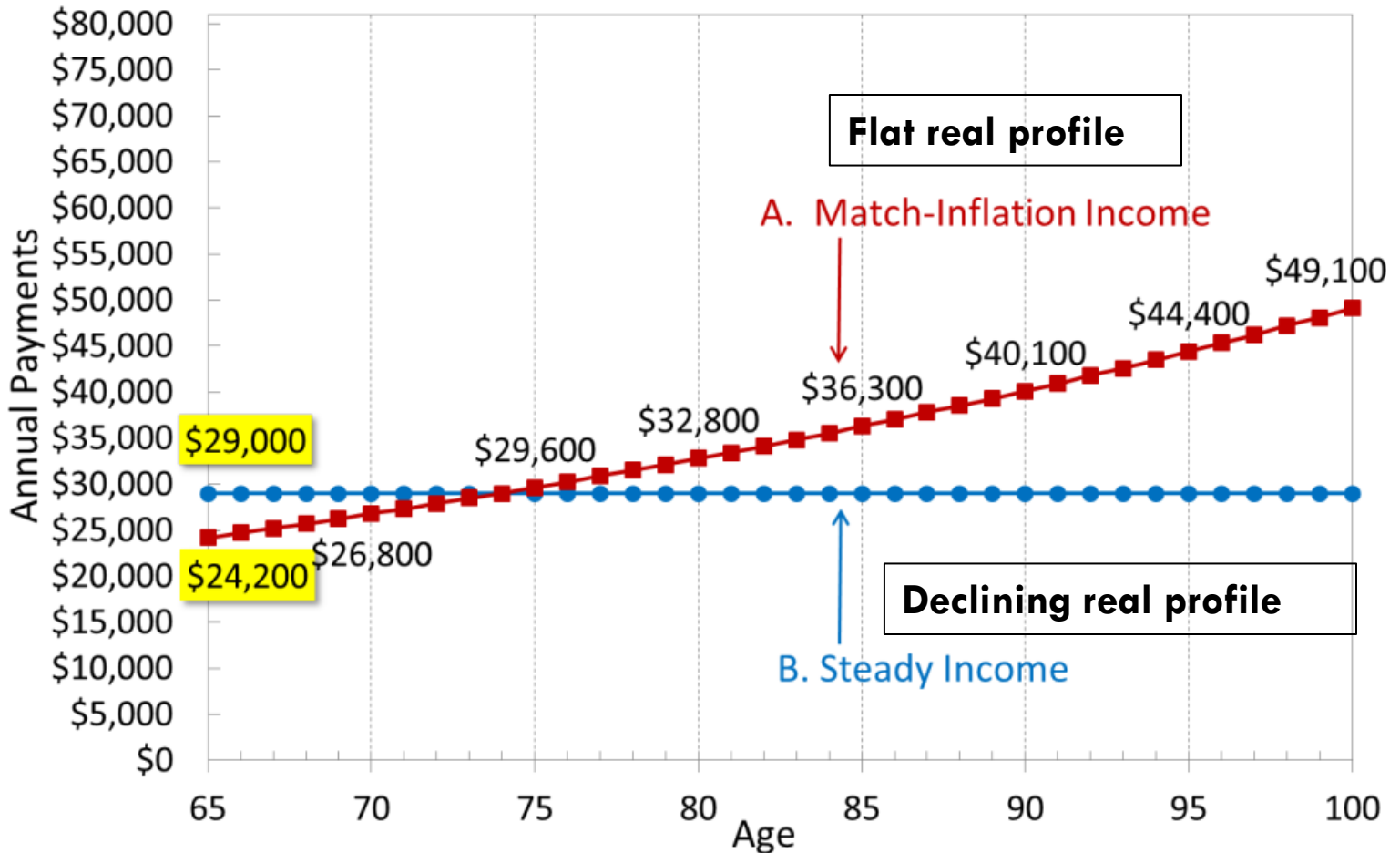
Annuity slope (real)	Growth rate of payments (real)	Choice 1	Choice 2
Declining	-2 %	■	
Flat	0 %		■
Rising	+2 %		■

- In all cases PV of payments identical

Nominal payment profiles shown to participants: Choice 1

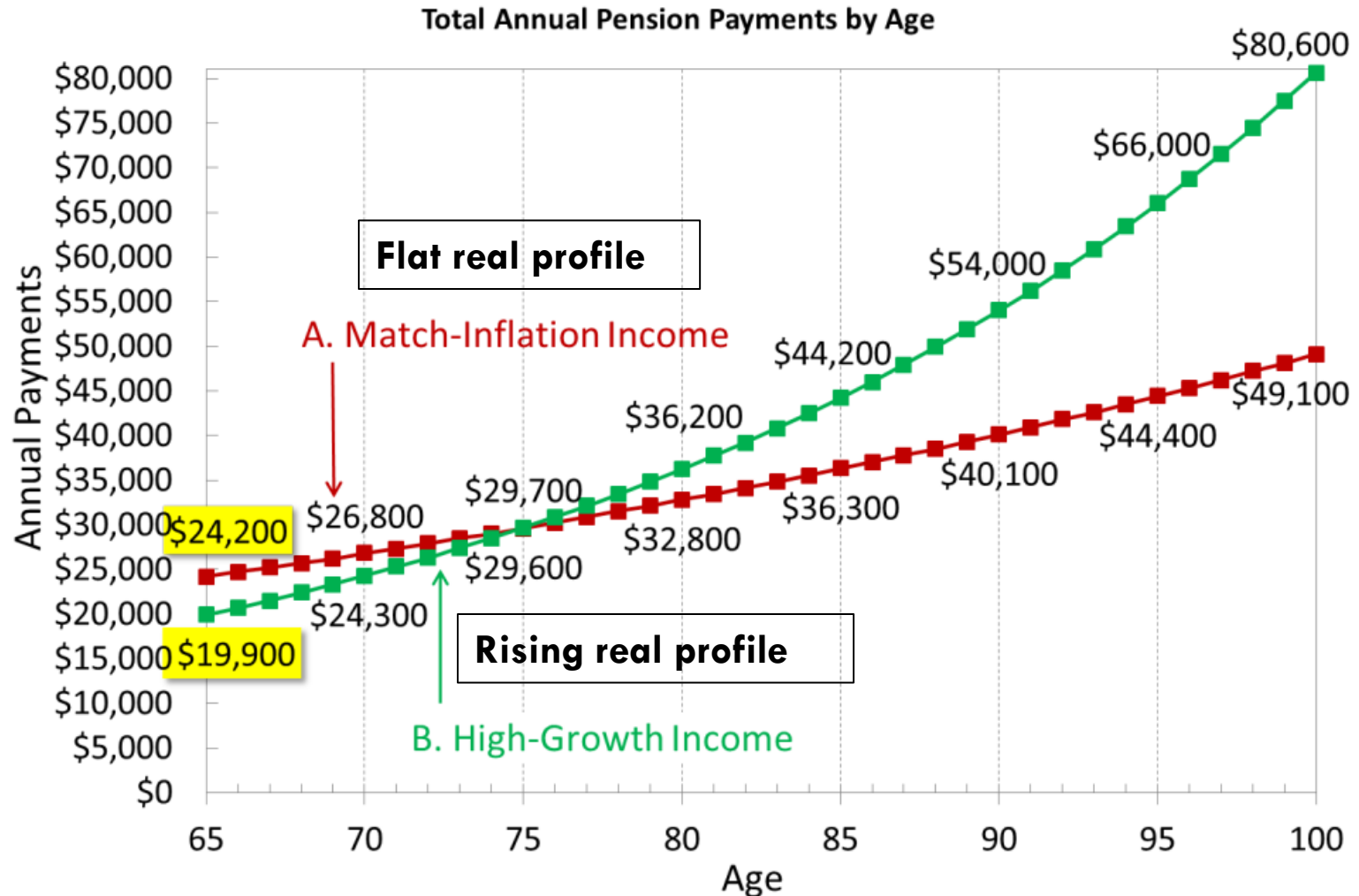
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Total Annual Pension Payments by Age



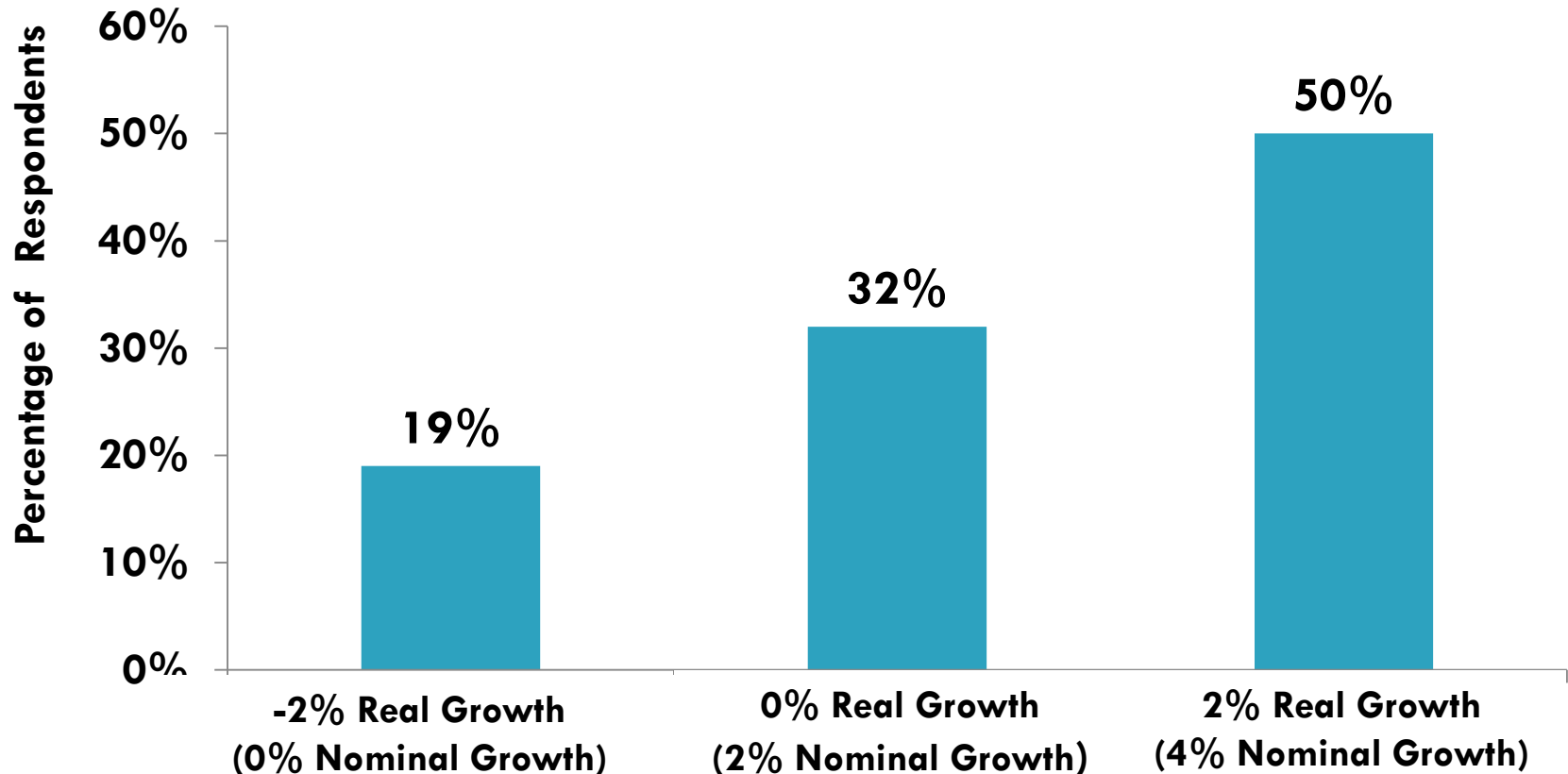
Nominal payment profiles shown to participants: Choice 2

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Results: what kinds of payout slopes do people want? (S1)

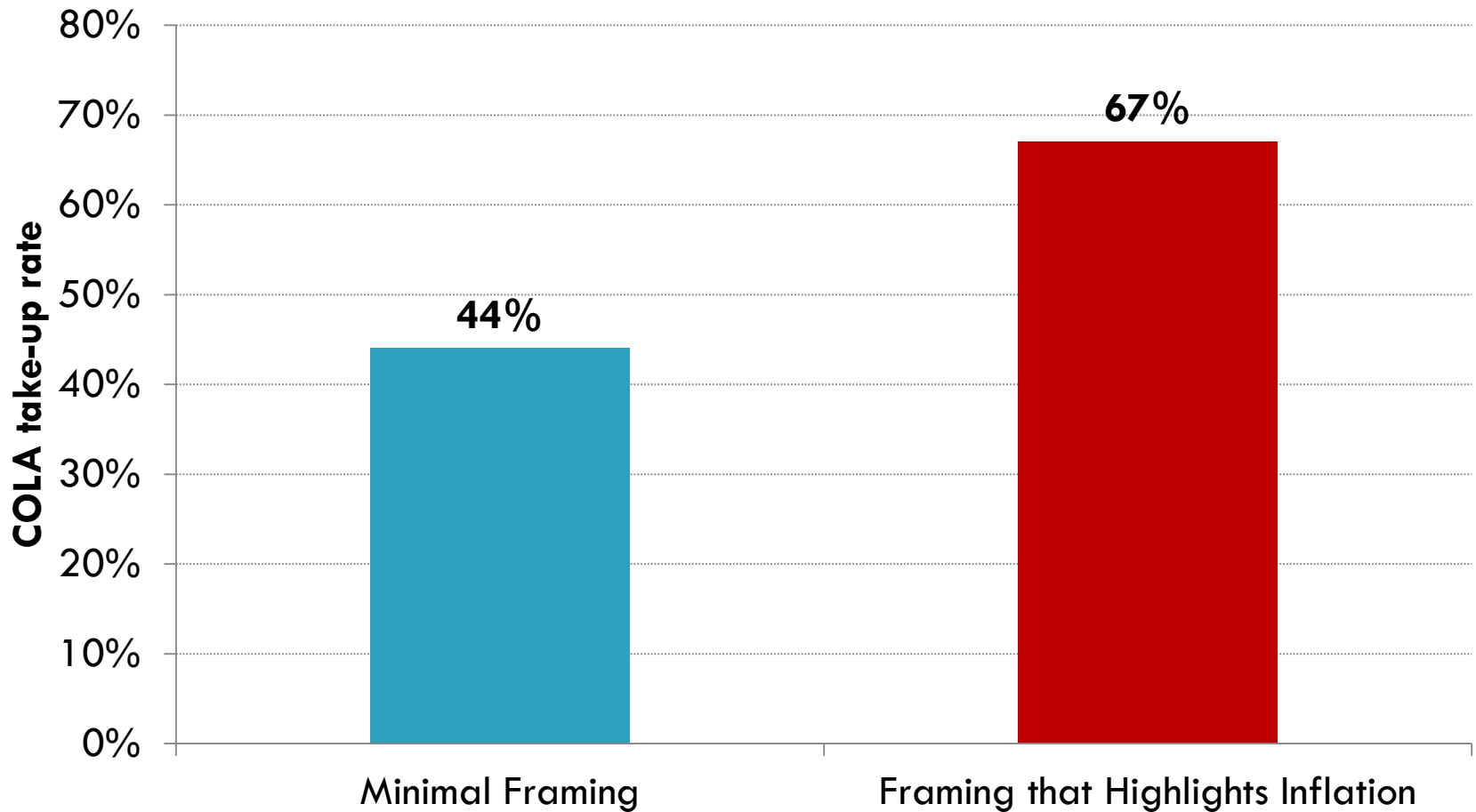
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Individuals dislike declining real pension payouts

Framing and COLA take-up rates (S2)

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COLAs: takeaways

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- Strong dislike of declining real (flat nominal) payouts—individuals would prefer inflation protection or a payout stream that grows at a rate higher than inflation
- Highlighting the decline in purchasing power arising from inflation significantly increases the demand for COLAs

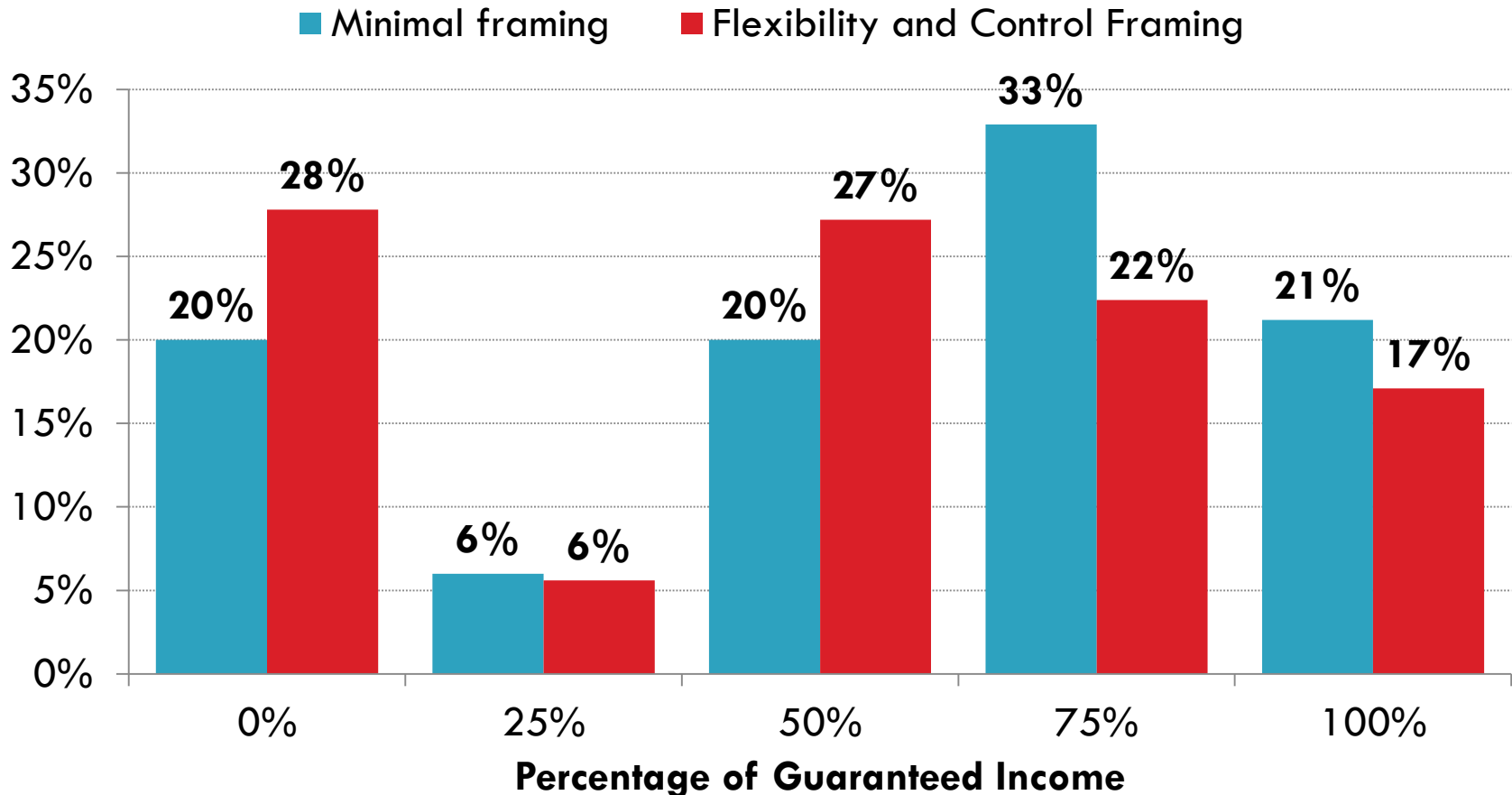
Framing effects: Does changing language alter annuitization choices?

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- Framing Treatments
 - ▣ Baseline: Minimal Framing
 - ▣ Alternatives
 - Flexibility and Control
 - Investment Framing
 - Good Deal
 - Total Income
 - Longevity Insurance
 - Mortality credits

Framing: Flexibility and Control

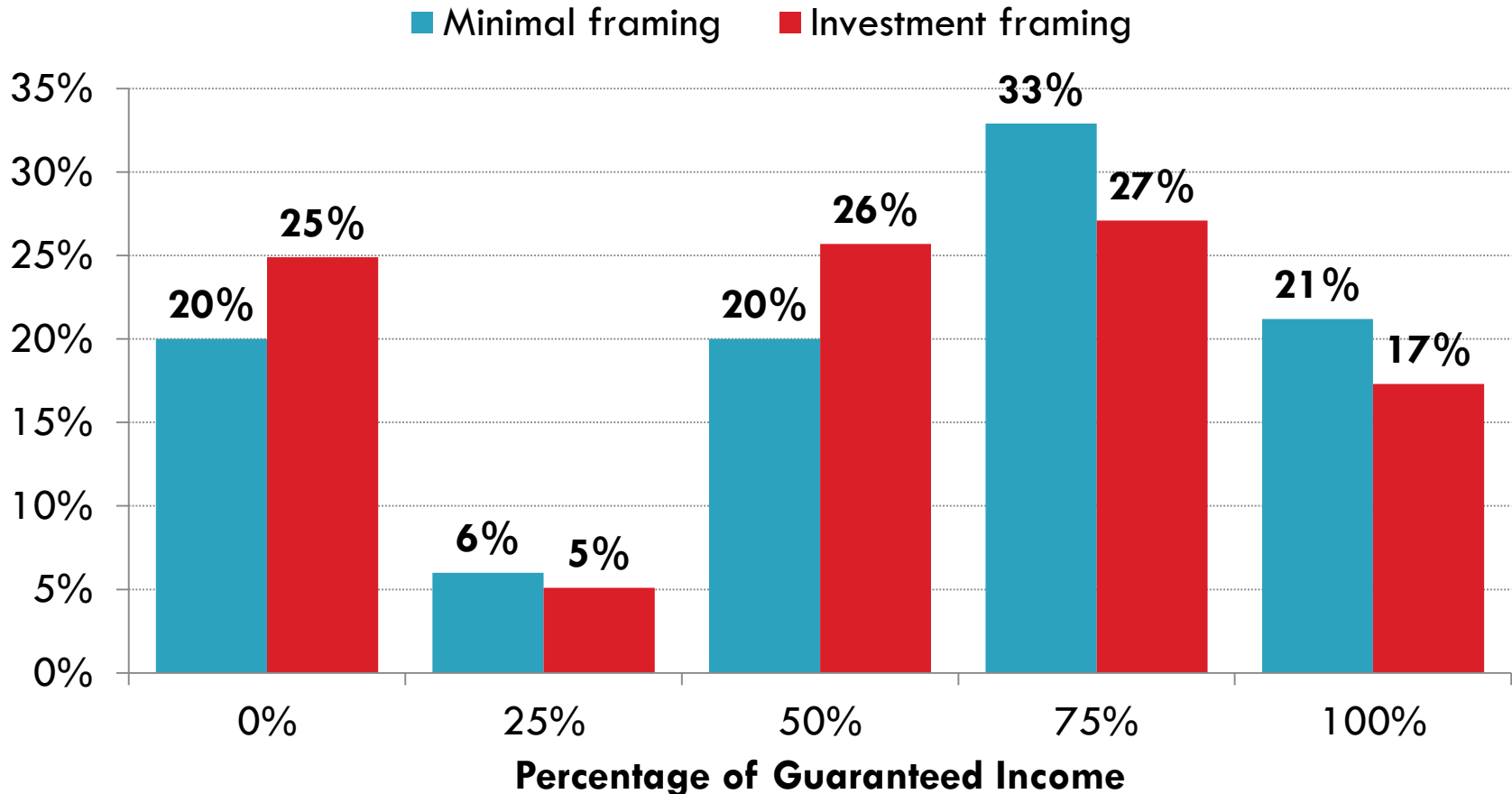
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Highlighting that annuitization reduces flexibility and control reduces annuitization rates by 8.4 percentage points

Framing: Investment

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**Framing annuitization as an investment
reduces annuitization rates by 5.6 percentage points**

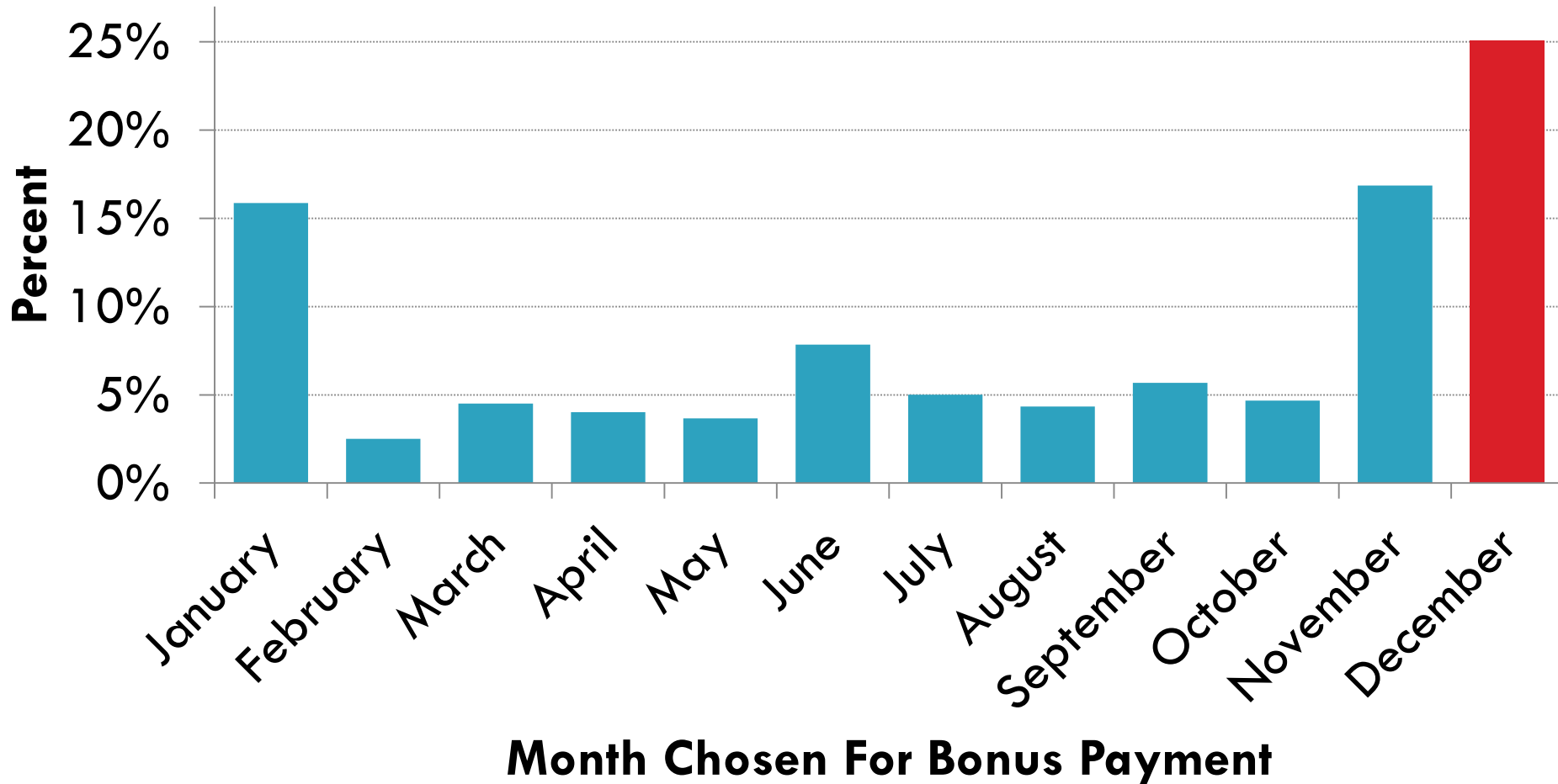
Standard annuity vs. annuity with bonus

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- Standard Annuity
(\$2,000/month)
- Annuity with a bonus
(\$1,900/month + \$1,200 in
month of your choosing)

Preferences for bonus timing: holiday season

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Summary of key findings

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- What do people say is important?
 - ▣ Obstacles: loss of flexibility/control, counterparty risk
 - ▣ Motivations: ensure late life income
- Allowing partial annuity option increases annuitization
- COLAs
 - ▣ Individuals do not want declining real income paths
 - ▣ Highlighting inflation increases COLA take-up rates
- Framing influences choices
 - ▣ Flexibility and control
 - ▣ Investment
- Substantial demand for annuities with bonus payments

Next steps in our research program

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- Build behavioral model of annuity choices
- Obtain and analyze data on annuitization choices made by individuals in actual DB and DC settings
- Use lessons from behavioral economics to improve
 - ▣ Choice architecture
 - ▣ Product design
 - ▣ Public policy
- Study any resulting changes in behavior