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Behavioral Obstacles in the Annuity Market

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Abstract

As Baby Boomers enter retirement, they will look to the investment industry for ways to generate income from accumulated savings. Why most retirees do not purchase longevity insurance in the form of lifetime annuities is a long-standing puzzle. Mental accounting and loss aversion can explain the unpopularity of annuities by framing them as risky gambles where potential losses loom larger than potential gains. Moreover, behavioral anomalies can explain the prevalence of “period certain” annuities, which guarantee a minimum number of payouts. Finally, investors may prefer “longevity annuities” purchased today to begin payouts in the future to immediate annuities because investors overweight the small probability of living long enough to receive large future payouts.

As Baby Boomers enter retirement, they will look to the investment industry for ways to generate retirement income from a stock of accumulated savings. A significant focus

for the industry is whether retirees are adequately protected against longevity risk (the risk of outliving their assets). Baby Boomers are less likely to have the high degree of guaranteed lifetime income that was formerly provided by defined-benefit pensions. But a natural replacement for a DB pension is a lifetime income annuity purchased from retirement savings. Why most retirees do not purchase longevity insurance in the form of lifetime annuities is a long-standing puzzle.

This study applies the lessons of behavioral finance to understand how well-documented anomalies in decision making under risk may affect the annuity purchase decision, even when longevity risk is the only risk being considered. The investment industry’s success at helping manage retirees’ longevity risk will depend heavily on understanding these powerful behavioral influences on the way retirees evaluate annuity products.

We demonstrate that mental accounting can explain the unpopularity of annuities because it causes individuals to view annuities as gambling on their own lives. When annuity outcomes are segregated from their impact on total retirement spending, then purchasing an annuity appears to be a gamble that increases overall risk rather than a form of insurance that can reduce risk. Loss aversion exacerbates the distortion by making the potential loss (from not making back the initial investment) loom larger than the potential gain. We also explain the prevalence of “period certain” annuities, which guarantee a minimum number of payouts. These annuities effectively combine a bond portfolio with an annuity that starts payouts in the future, and mental accounting may give the impression that this bond-plus-annuity combination is less risky than an immediate annuity, in which all payouts are subject to mortality risk (uncertainty about the date of death).

Finally, we show that a recent innovation in annuity markets—delayed-payout or “longevity” annuities, which are purchased today to begin payouts in the future—may be more desirable than immediate-payout annuities. This behavioral pattern is caused by the overweighting of small probabilities. In the case of longevity annuities, the overweighted small probabilities are associated with large cumulative payouts if one lives long enough to earn back multiple times the initial investment.

To combat these behavioral distortions, particularly mental accounting, annuity marketers and financial advisers need to frame annuities in the context of an overall retirement spending plan. Achieving this goal should convince more retirees that the

normative economic conclusion is true: They should annuitize some part of their retirement savings. Holding longevity insurance in the form of an annuity should reduce the need for precautionary saving and thus allow annuity holders to consume more in retirement.

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