What Makes Annuitization More Appealing?

JOHN BESHARES, JAMES J. Choi, DAVID LAIBSON, BRIGITTE C. MADRIAN, AND STEPHEN P. ZELDES

Many households resist annuitization. When a lump-sum payment is available in a U.S. defined benefit (DB) pension plan, 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. Only about 10% of defined contribution (DC) plan participants who leave their jobs after age 65 annuitize their assets. Resistance to annuitization is often referred to as the “annuitization puzzle,” since the benefit of buying insurance against outliving one’s savings should theoretically create strong demand for annuities.

In this paper, we identify some of the factors that influence consumer attitudes toward annuitization, focusing on product design and choice architecture. To study this issue, we field two surveys in which we elicit 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 choice, influences outcomes, 3) what intertemporal slope of annuity payouts people prefer, 4) whether altering the framing used to describe options influences the rate of annuitization, 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.

Five findings emerge from our surveys. First, respondents report that three considerations (one positive and two negative) are the most important for their choices about annuitization: “Want to make sure I have enough income later in life,” “Want flexibility in the timing of my spending,” and “Worried about company not being able to pay me in the future.” This third factor suggests that policy makers could increase annuity demand if they adopt policies that reduce the fear of counterparty risk. For example, policy makers could make more salient existing institutions that mitigate counterparty risk, including back-stop state insurance funds.

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 a choice between taking a lump sum and an annuity, but combinations of the two are less common.

Third, holding the present value of expected payments fixed, very few respondents choose declining real income paths. Our respondents prefer flat or rising real paths. This result underscores how puzzling the paucity of inflation-indexed annuities in the marketplace is. We find that highlighting the effects of inflation on real payout values increases people’s 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 risk.
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 marginal utility of money is low to states where one is alive and the marginal utility 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 traditional uniform-payout annuity. 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’ statement that they value flexibility in the timing of their spending. 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 slopes.

The paper’s results have several implications for annuity product design and choice architecture. 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. Another example is an annuity with multiple annual bonuses. 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). Finding a product design that people would choose is a significant challenge, but one that is worth taking on because of the scope for large potential welfare benefits.

The full working paper is available on our website, [www.nber.org/programs/ag/rrc/books&papers.html](http://www.nber.org/programs/ag/rrc/books&papers.html) as paper NB12-06.

JOHN BESHEARS is Assistant Professor of Finance at Stanford University Graduate School of Business and an NBER Faculty Research Fellow.

JAMES CHOI is Associate Professor of Finance at the Yale School of Management and an NBER Faculty Research Fellow.

DAVID LAIBSON is Harvard College Professor at Harvard University and an NBER Research Associate.

BRIGITTE MADRIAN is the Aetna Professor of Public Policy and Corporate Management at Harvard’s Kennedy School of Government and an NBER Research Associate.

STEPHEN P. ZELDES is the Benjamin M. Rosen Professor of Economics and Finance at Columbia Business School an NBER Research Associate.